JUDITH S. LAMBERT*†

11

SUBCHAPTER S CORPORATIONS

*Biographical information for Ms. Lambert appears on page 7-1 of this manual.

†John J. Lancaster was the author of this chapter in the previous edition of this manual.

I. SELECTION OF SUBCHAPTER S CORPORATION AS BUSINESS ENTITY

A. [§11.1] In General

Various nontax considerations such as limited liability, free transferability of interests, and centralized management have led business entrepreneurs and investors to select the corporate form for doing business or engaging in investment activities. Income tax considerations, however, have also played a significant role in the entity selection process.

The general rules governing the federal income taxation of corporations are in subchapter C of the Internal Revenue Code, *IRC* §§301 *et seq.*, which provides a two-tiered system of income taxation. A tax is first imposed at the corporate level on income derived by the corporate entity, and a second level of tax is then triggered on distributions to shareholders to the extent of the corporation's current or accumulated earnings and profits.

This nonintegrated, double-tax system, a hallmark of the federal method for taxing corporations, has inspired many business people and investors to opt out of the corporate form (especially after the Tax Reform Act of 1986) and select the partnership or sole proprietorship vehicle, including the use of single-member, disregarded limited liability companies, for engaging in business to avoid an additional tax on income at the entity level. The subchapter S corporation provides an alternative corporate form taxed similarly to a partnership.

B. Development Of Subchapter S Corporation

1. [§11.2] Initial Legislation

Cognizant of the disparity in the net-after-tax proceeds for business operations between shareholders in a small business corporation and partners in a partnership, President Eisenhower proposed in 1954 that corporations with a small number of shareholders who actively participate in the business of the corporation be taxed similarly to partnerships. Four years later, Congress enacted subchapter S of the Internal Revenue Code, *IRC* §§1361–1379, which allowed an electing small business, or "subchapter S" corporation, to avoid double taxation on earnings distributed to shareholders, similar to the treatment given sole proprietorships and partnerships. Moreover, losses generated by an S corporation were permitted to be deducted on the shareholder's return, which was denied shareholders of regular corporations under the general subchapter C provisions.

Notwithstanding the attempt at parity with unincorporated ventures, subchapter S often presented complex and formidable tax traps for the unwary or uninformed. For example, application of the eligibility provisions frequently resulted in an inadvertent termination of the election, which had significant adverse tax consequences at both the corporate and shareholder levels. Moreover, the distribution provisions under subchapter S incorporated a complex maze of distributional priorities that had to be applied before determining the tax status of a particular distribution. Finally, a current year's losses in excess of a shareholder's stock (and debt) basis could not be carried over into a subsequent year, as is permitted for partners under the partnership rules. The risks associated with the possibility of an inadvertent termination of the ability to distribute previously taxed income without a second round of tax encouraged taxpayers to avoid subchapter S unless they were prepared to undertake the cost and effort of maintaining constant vigilance over corporate and shareholder events.

2. [§11.3] Subchapter S Revision Act Of 1982

The Subchapter S Revision Act of 1982 (SSRA), Pub.L.No. 97-354, 96 Stat. 1669, was signed into law on October 19, 1982. SSRA made substantial revisions in subchapter S, eliminating many of the problem areas encountered under previous law by using principles similar to those governing partners and partnerships under subchapter K. As a result, the tax impact of business operations conducted at the corporate level is passed through directly to shareholders and reported as separate items of income, deduction, credit, and loss rather than as an aggregate item composed of dividend income or net operating loss as it was under previous law. See §§11.78–11.80. Other reforms introduced as part of SSRA included revisions governing eligibility, elections, and terminations, in an effort to avoid the hardships suffered by taxpayers under prior law. The distributional rules were also simplified for S corporations that do not have a history as a regular or C corporation. However, the distribution rules are complex for corporations that convert from C to S status.

Despite removing some of the previous impediments to using subchapter S, these amendments significantly restricted the ability of an S corporation and its shareholders to report income using different taxable years to allow shareholders to defer the reporting of corporate-level income.

Moreover, the corporate fringe benefit rules, which historically were available to employees of an electing corporation, were removed for shareholder/employees owning more than 2% of the value of stock in an S corporation. See §11.118.

3. [§11.4] Tax Reform Act Of 1986

The changes in the taxation of corporations and their shareholders introduced by the Tax Reform Act of 1986 (TRA 86), Pub.L.No. 99-514, 100 Stat. 2085, increased the desirability of electing subchapter S status, both for existing C corporations and for newly organized corporations. Beginning in 1987, the maximum rate of tax on individuals (38.5% for 1987 and 28% thereafter) was for the first time less than the maximum federal corporate rate (40% for 1987 and 34% thereafter). Second, S corporations were not subject to the new preference tax on financial accounting or "book" income (now current adjusted earnings and profits) added by TRA 86 under the corporate alternative minimum tax. *IRC* §56(g)(4). Shareholders in S corporations were also permitted to deduct entity-level losses on their individual returns if the amounts could overcome the at-risk and passive activity loss rules contained in *IRC* §§465 and 469, respectively. See §§11.113–11.115. Finally, and perhaps most significantly, the repeal of the "General Utilities" doctrine, which had for years enabled corporations to sell substantially all of their assets, completely liquidate them, or both, and avoid double taxation, cemented the nonintegrated system of double taxation for shareholders owning stock in C corporations.

Congress was aware, however, that an election under subchapter S would be an easy way to avoid the full impact of TRA 86's repeal of the General Utilities doctrine, and preserved a system of double taxation on the untaxed asset appreciation and other items of "built-in gains" of a regular corporation for a 10-year period after conversion to S status. See §§11.105–11.107.

4. [§11.5] Recent Acts

The Small Business Job Protection Act of 1996 (SBJPA), Pub.L.No. 104-188, 110 Stat. 1755, liberalized many S corporation provisions. The Act increased the maximum number of permitted shareholders of an S corporation from 35 to 75. See §§11.18, 11.20. The Act also permitted an S corporation to own 80% or more of the stock in a C corporation, and, for the first time, an S corporation was permitted to own a "qualified Subchapter S subsidiary" (QSSS). See August & Rubinger, *Long Awaited Proposed Regulations on S Corporation Subsidiaries Issued*, 15 J. Partnership Tax'n 278 (Fall 1998). Under the SBJPA, an "electing small business trust" (ESBT) and certain tax-exempt entities were made eligible to own stock in an S corporation. See §§11.30–11.31. Furthermore, the Act granted the Internal Revenue Service (the IRS or Service) the authority 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 and to treat a late S election as timely. See §11.48. For a detailed discussion of the SBJPA, see August, *New Law Liberalizes S Corporation Provisions*, 14 J. Partnership Tax'n 50 (Spring 1997).

The American Jobs Creation Act of 2004 (AJCA), Pub.L.No. 108-357, 118 Stat. 1418, further liberalized S corporation provisions. The Act increased the maximum number of permitted shareholders of an S corporation from 75 to 100. See §§11.18, 11.20. Additionally, the AJCA treated any and all family members as one total shareholder for purposes of the 100-shareholder rule if any member of the family made an election under *IRC* §1361(c)(1). The Gulf Opportunity Zone Act of 2005, Pub.L.No. 109-135, 119 Stat. 2577, eliminated, after December 31, 2004, the need to make an election for family members to be treated as one shareholder. Furthermore, under the AJCA, spouses could no longer transfer stock to each other and realize losses or deductions from the transaction in the same year.

Under the American Recovery and Reinvestment Act of 2009, Pub.L.No. 111-5, 123 Stat. 115, Congress temporarily reduced the 10-year holding period on conversion from a C to an S corporation to avoid a tax on any built-in gains from 10 years to 7 years for sales occurring in 2009 and 2010. In addition, under the Small Business Jobs Act of 2010, Pub.L.No. 111-240, 125 Stat. 2556, the period was reduced to five years for sales occurring in 2011. *IRC* §1374(d)(7)(B). This five-year period was extended for the 2012 and 2013 tax years by the American Taxpayer Relief Act (ATRA) of 2012, Pub.L.No. 112-240, 126 Stat. 2313.

C. Considerations In S Corporation Election

1. [§11.6] Pass-Through Of Losses And Credits

Many small businesses sustain losses during their early stages of operation. With a regular or subchapter C corporation, losses from operations are trapped at the corporate level and will be of benefit only when (and if) the corporation becomes profitable. Net operating losses of C corporations may be carried back two years and forward twenty years (only carried forward for Florida corporate income tax purposes). *IRC* §172; *F.S.* 220.13. Net capital losses of C corporations may be carried back three years and forward up to five years (only carried forward for Florida corporate income tax purposes). See *IRC* §§1212(a)(1)(A)–(B). On the other hand, when subchapter S status is elected, losses incurred at the corporate level "flow through" to the shareholders and generally are deductible on their individual returns. Limitations are imposed on the extent to which these deductions may be claimed in the current year. See *IRC* §§1366(d), 465, 469. This conduit approach to governing S corporations also applies to the pass-through of qualifying business credits for corporate asset purchases. See §§11.78–11.80.

2. [§11.7] Taxation Of Profits

For a profitable corporation, the use of an S election may significantly reduce the total taxes on corporate profits distributed to the shareholders. A regular corporation is subject to tax on income at rates set forth in *IRC* §11(b). When net profits are distributed to C corporation shareholders, a second tax is required at the individual level to the extent of the corporation's earnings and profits. When the distribution of corporate-level earnings is received as part of a complete liquidation of the corporation or complete redemption of the shareholder's interest (*i.e.*, *IRC* §302(b)(3) redemption), the shareholder-level gain is potentially subject to more favorable tax treatment as long-term capital gain.

In contrast, an S corporation generally will not be subject to tax because its income is passed through and taxed solely at the shareholder level for the year in which the corporation's taxable year ends. (The only exceptions apply to special circumstances concerning conversion of a C corporation to an S corporation.) Once the taxable income of the S corporation is determined, it is passed through to each shareholder in accordance with the daily stock ownership percentages. The same applies concerning corporate-level deductions or losses. The taxable income that then passes through is included in each shareholder's gross income for filing with his or her individual return, and is presented on IRS Schedule K-1 (Form 1065). The next analytical step is to add to each shareholder's basis in his or her stock the amount of income that is passed through. Based on the increased basis, an S corporation may distribute cash in an amount equal to the adjusted or increased basis of the shareholder without resulting in further shareholder-level tax. After accounting for the distribution, the go-forward basis is reduced by the same amount. When the distribution is made in property other than cash, the same rules apply, but the distribution may have consequences to the corporation. Specifically, when the distribution is made with property that has a value in excess of its tax (depreciated) basis, gain results to the corporation. This gain is distributed to all shareholders — not just the shareholder receiving the appreciated property. When the property has a tax basis in excess of its value, loss is not allowed even though the property's basis in the hands of the shareholder/distributee is limited to fair market value.

Despite this apparent advantage, a profitable business that needs to retain and reinvest profits for working capital may be better advised not to elect subchapter S status for two reasons. First, although the maximum federal income tax rate on corporations is currently 34% (35% for earnings over $10 million), plus additional corporate incremental taxes of up to $100,000 (see *IRC* §11(b) flush paragraph), plus a 5.5% Florida corporate income tax that is deductible in computing federal taxable income, the first $75,000 of income of a corporation that is not a personal service corporation is subject to a surtax exemption. Taxable income up to $50,000 is taxed at a rate of 15%, and taxable income between $50,000 and $75,000 is taxed at a rate of 25%. The benefit from using the surtax exemption, which in certain instances must be shared with other related corporations and may not be used by a personal service corporation, may, especially in a start-up situation in which the shareholders are in maximum tax brackets, outweigh the advantages of an S election.

Shareholders in an S corporation are also subject to tax on corporate profits without regard to actual distributions. Thus, shareholders in an S corporation may suffer a cash flow problem when trying to meet their federal income tax obligation on the pass-through of corporate-level income if cash is retained in the corporation to provide working capital for operations. This is particularly problematic for shareholders in a corporation converting to S status.

On the other hand, when it is anticipated that the initial years of the corporation's activities will result in losses, an S election may permit the losses to be passed through and reported on the shareholders' returns. The limitation under subchapter S is that the losses are limited to each shareholder's basis, as adjusted for prior years' income or loss allocations, as well as for stock distributions and, once stock basis has been reduced to zero, to debt or other advances made by the shareholder to the corporation. In contrast, losses of a C corporation are reportable only at the corporate level against corporate income, even if the corporation subsequently converts to S status.

Issues concerning the available projected cash flow from operations of an S corporation should be reviewed with clients before filing an S election. This aspect of the operation of an S corporation is also the proper subject for specific provision in a shareholders' agreement, such as requiring the S corporation to distribute a minimum amount of cash to each shareholder on dates coinciding with the dates for paying estimated and annual income taxes.

3. [§11.8] Passive Investment Income

The 1982 SSRA legislation (see §11.3) repealed a former limitation on the amount of passive income that could be derived by an S corporation. In its place, there is only a limitation on an S corporation deriving a substantial portion of its receipts from items such as dividends, interest, and royalties, provided it has undistributed earnings and profits from prior C years. In that event, an uninterrupted period of three years of passive investment income equaling 25% of gross receipts and undistributed C-year earnings and profits will cause the corporation to forfeit its subchapter S election. See *IRC* §1362(d)(3). In addition, these S corporations with passive income and a prior (profitable) C corporation history are subject to a corporate-level tax under *IRC* §1375 (and also subject to the Florida 5.5% corporate income tax, see http://dor.myflorida.com/dor/taxes/corporate.html).

A new S corporation, or a former C corporation with no undistributed C-year earnings and profits, may derive all of its income from passive sources without jeopardizing its subchapter S election. An S corporation, therefore, can serve the needs of one or more shareholders who wish to be passive investors in a particular business venture or set of undertakings. However, even a corporation that has always been an S corporation can pick up undistributed C-year earnings and profits as a result of a nontaxable corporate merger or other acquisition. See §§11.108–11.111 for further discussion of passive investments.

Despite the apparent benefits of electing subchapter S status for holding investment assets, there are situations in which selection of a different entity vehicle, such as a partnership or limited liability company, may be more advisable:

- Existence of passive investment income. See §§11.108–11.111.
- Income allocated among family members. See §11.87.
- Distribution of appreciated property by the corporation to its shareholders. See §§11.101–11.102.
- The investment company limitation rule of *IRC* §351(e)(1), which disqualifies tax-free incorporations when the effect of incorporation is to diversify an investment portfolio.

4. [§11.9] Real Estate Holdings

Subchapter S corporations are good vehicles for the development and sale of real estate. An S corporation offers developers limited liability under the corporate form, which is essential in defending against lawsuits for construction defects and other third-party claims. Further, the subchapter S election also eliminates the double-tax cost of a regular corporation.

For rental realty, unless the corporation has a prior C history and undistributed C-year earnings and profits and derives a significant portion of its gross receipts from rents, the S corporation will pass through rental income without double tax to its shareholders and without risking the loss of the subchapter S election. If the passive investment rules come into play, however, planning rental operations of an S corporation will require careful study and evaluation. Under revised and more favorable regulations, rents will generally not constitute passive income if the corporation provides significant services or incurs substantial costs in the rental business. See *Treas.Reg.* §1.1362-2(c)(5)(ii)(B)(2). When the real estate rental intensive C corporation seeks to convert to S status, substantial consideration must also be given to potential application of the corporate-level tax on built-in gains under *IRC* §1374. See §§11.105–11.107.

Another consideration is the impact of the loss limitation rule under subchapter S (see §11.85), the at-risk rules (see §§11.116–11.117), and the passive activity loss provisions (see §§11.108–11.111), which may operate to restrict or suspend otherwise available losses for shareholder-level reporting. For example, shareholders in an S corporation are not permitted to report an increase in their stock basis for loss purposes by their pro rata share of corporate-level debt, even if they personally guarantee repayment. In contrast, partners in a partnership who are liable for the repayment of a partnership debt are frequently permitted to add their individual shares of the indebtedness in computing their basis in their partnership interest. However, if a particular rental project is not highly leveraged and generates cash flow from operations, use of an S corporation may still be a viable alternative.

5. [§11.10] Foreign Operations

SSRA repealed a former prohibition on an S corporation deriving more than 80% of its gross receipts from foreign operations. Since 1983, an S corporation may freely engage in foreign operations. Foreign tax credits paid by the corporation pass through to the shareholders subject to restrictions or limitations. See *IRC* §1363(c)(2)(B). Practitioners should note, however, that only United States citizens or aliens who reside in the United States may own stock in an S corporation. See *IRC* §1361(b)(1).

D. Comparison With Partnerships

1. [§11.11] In General

Because subchapter S corporations are taxed in a manner similar to partnerships, a comparison of these two forms of doing business is essential. Furthermore, there has been increasing use of the limited liability company (LLC) in the United States after the Internal Revenue Service issued a ruling in 1988 that favored its tax status as a partnership. Other new entity forms include the limited liability partnership (LLP) and the limited liability limited partnership (LLLP). The LLC, like the limited partnership, has none of the eligibility limitations that are imposed on an S corporation. LLCs, assuming they are structured to be taxed as partnerships, have the further advantage that all members have the characteristic of limited liability without regard to capitalization. In contrast, at least one partner of a limited partnership must have substantial assets or make meaningful contributions to the limited partnership for the limited partnership to lack the corporate characteristic of limited liability.

Use of the LLP or LLLP concept had historically been limited to businesses engaged in the rendering of professional services, such as the practice of law or medicine. Now, the LLP and LLLP are available for use in all business ventures. The principal state law benefit of the LLP, which is otherwise treated as a general partnership, is that the law removes the concept of joint and several liability among the members. The LLLP is a spin on the LLP with each partner, including the general partner, having limited liability.

Although S corporations are generally treated as pass-through entities for federal and state income tax purposes and thereby closely resemble partnerships, including LLCs, LLPs, and LLLPs, for federal income tax purposes, important and often critical differences remain.

For purposes of this chapter, unless otherwise indicated to the contrary, reference to the term "partnership" includes all entities that are taxable as partnerships for federal income tax purposes, including general partnerships, limited partnerships, LLCs, LLPs, and LLLPs.

2. [§11.12] Entity-Level Tax

An S corporation, unlike a partnership, is not totally immune from entity-level taxes. Three entity-level taxes apply to an S corporation; two of these apply to an S corporation with a prior C history. These corporate-level taxes include

- the built-in gains tax under *IRC* §1374 (see §§11.105–11.107), and
- the "sting" tax on excess passive investment income under *IRC* §1375 (see §§11.108–11.111).

Florida also taxes S corporations on federal taxable income. Accordingly, there is a 5.5% state income tax on taxable built-in gains or passive investment income.

A corporate-level income tax is also imposed on a corporation that converts from a C corporation to an S corporation to the extent of the spread between LIFO (last-in first-out) inventory and FIFO (first-in first-out) inventory methods in accordance with *IRC* §1363(d). This corporate-level tax on the LIFO-FIFO spread occurs over a four-year period beginning with the corporation's final C-year return. This LIFO recapture tax, as with the more well-known S-corporation-level taxes, can be a significant drawback to converting to S status. For more information on LIFO recapture, see §11.112.

3. [§11.13] Distributions

A second difference giving partnerships advantages over S corporations pertains to distributions. Generally, any distribution of appreciated property from an S corporation to shareholders is treated as a taxable sale between the corporation and a third party for the fair market value of the property, with the income being passed through to the shareholders in proportion to their stock ownership for inclusion on their individual returns. The value of the distribution will also be taxed to the shareholder to the extent the amount exceeds the distributee shareholder's stock basis, as increased for the pass-through of corporate-level income on the distribution.

In contrast, distributions of appreciated property from a partnership to its partners will generally not be taxed to either the partnership or the partners unless (1) the distribution is deemed to be "disproportionate" (non-pro rata) with respect to two general classes of partnership assets in accordance with *IRC* §751(b), or (2) the distribution is described in the limited circumstances specified in *IRC* §§704(c)(1)(B) or 737.

4. [§11.14] Entity-Level Debt

Shareholders in an S corporation are restricted from including entity-level debt in their stock basis, limiting their ability to deduct losses from S operations on their individual returns. This result does not change even if the shareholder personally guarantees the corporate obligation. See *IRC* §1366. In contrast, partners are generally permitted to share in liabilities at the entity level to the extent they share in the obligation to repay, which may substantially increase their basis in their partnership interest. *IRC* §752(a). This results in an increased ability to report tax losses on a current basis. This is the federal tax characteristic that makes a partnership a more attractive entity for leveraged activities than an S corporation.

This outside basis comparison may be reduced significantly in importance, however, by the loss limitation rules in either *IRC* §465, the at-risk provisions, or *IRC* §469, the passive activity loss rules. See

§§11.113–11.117 for discussion of these provisions.

5. [§11.15] Allocations In Proportion To Stock

Shareholders in an S corporation may not allocate tax items in a manner disproportionate to their percentage of stock ownership. This follows from the long-standing limitation that an S corporation may issue only one class of stock. *IRC* §1361(b)(1)(D). This translates into a facts-and-circumstances test that determines whether all shareholders have identical rights of distribution and liquidation. See §11.21. Differences in stock based on voting are permitted.

The one-class-of-stock limitation must be contrasted with the special allocation rule provided in the partnership area, under which partners may allocate differences in profits and losses, cash flow, and other items, provided these allocations have substantial economic effect that is determined in accordance with the regulation to *IRC* §704(b).

6. [§11.16] Reorganizations

Shareholders in an S corporation whose stock has appreciated substantially over time may be able to realize the economic appreciation in the corporation through receipt of stock in another corporation in a tax-free reorganization. In contrast, partners do not have the ability to make nontaxable swaps of equity positions involving more than a single partnership.

7. [§11.17] Eligibility Restrictions

Subchapter S corporations and their shareholders are still subject to various eligibility restrictions that may preclude consideration of subchapter S status. An investor in an S corporation may not be a corporation, partnership, ineligible trust, or nonresident alien. *IRC* §1361(b)(1)(B).

In contrast, there generally are no restrictions on persons eligible to be partners in a partnership. As mentioned in §11.11, state law governing creation of LLPs and LLLPs may limit their applicability to professionals. See §§11.18–11.42 for further discussion of subchapter S eligibility limitations.

II. SUBCHAPTER S CORPORATION REQUIREMENTS

A. Eligibility

1. [§11.18] In General

To file an election under subchapter S, a corporation must be a "small business corporation." This term is defined in *IRC* §1361(b) as an eligible domestic corporation having 100 or fewer eligible shareholders and not more than one class of stock. A corporation that satisfies the statutory requirements will be treated as an S corporation regardless of its economic size or whether it is actually engaged in a trade or business.

In contrast, partnerships have no eligibility restrictions other than the determination that the partnership entity, in its selected form (*e.g.*, limited partnership, LLC, LLP), at all times satisfies the criteria of the regulations under *IRC* §7701 and pertinent case law that the organization is taxable as a partnership for federal income tax purposes.

The following corporate entities are not eligible for S corporation status:

- Banks and financial institutions that use the reserve method of accounting for bad debts under *IRC* §585. *IRC* §1361(b)(2)(A).

- Insurance companies taxed under *IRC* subchapter L. *IRC* §1361(b)(2)(B).

- Corporations electing possession tax credits under *IRC* §936. *IRC* §1361(b)(2)(C).

- Domestic International Sales Corporations (DISCs) or former DISCs. *IRC* §1361(b)(2)(D).

2. [§11.19] Domestic Corporations And Associations

The electing corporation must be a "domestic corporation" — a corporation created or organized in the United States or under the laws of the United States or of a state. *IRC* §§1361(b)(1), 7701(a)(4); *Reg.* §301.7701-5. A corporation formed and organized outside of the United

States may not elect subchapter S status even though 100% of its business operations are conducted within the United States. Effective for taxable years beginning after July 21, 1995, an entity classified as an association taxable as a corporation may elect subchapter S status if it meets all other requirements. *Reg.* §§1.1361-1(c), (k)(2)(i).

3. [§11.20] Number Of Shareholders

An eligible subchapter S corporation must have 100 or fewer shareholders. *IRC* §1361(b)(1)(A). This is an increase from the maximum number of 75 allowed before enactment of the AJCA, the 35 allowed before enactment of the SBJPA, the 25 allowed before enactment of SSRA, and the original limit of 10 established in 1959.

Any and all members of a family are treated as a combined one shareholder for the 100-shareholder rule, regardless of whether the stock is owned jointly or individually. *IRC* §1361(c)(1). In the event of divorce, however, a former husband and wife are counted as two shareholders and are co-owners of stock. *Reg.* §1.1361-1(e)(2).

Until the Service issued *Rev.Rul.* 94-43, 1994-2 C.B. 198, it was uncertain whether strategies deployed to circumvent the restriction on the maximum number of shareholders would be successful. For example, under *Rev.Rul.* 77-220, 1977-1 C.B. 263, which was revoked in *Rev.Rul.* 94-43, the Service ruled that the subchapter S elections of three corporations, each possessing the maximum number of permitted shareholders and agreeing to be part of a joint venture, were invalid. Although *Rev.Rul.* 94-43 is clear authority that subchapter S corporations can enter into a joint venture with one another or other C corporations, it is unclear how the Service will rule on other attempts to avoid eligibility limitations under subchapter S through a joint venture or partnership of S corporations.

4. Classes Of Stock

a. [§11.21] In General

An S corporation may issue only one class of stock. *IRC* §1361(b)(1)(D). The rationale for this rule is to simplify tax administration by avoiding consideration of special priorities for allocating profits, dividends, and liquidating distributions in determining the income tax consequences at the shareholder level. This prevents equity participants in an S corporation from making special allocations of profits, changing cash flow, or establishing distribution priorities. *Reg.* §1.1361-1(*l*)(1) states that a corporation will be considered as having more than one class of stock if the shares of outstanding stock do not confer identical rights to distribution and liquidation proceeds. As stated in §11.22, differences in voting rights are permitted. *IRC* §1361(c)(4).

The determination of whether all outstanding shares confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds. Routine commercial contractual agreements such as leases, employment agreements, and loan agreements will not be considered binding agreements relating to distribution and liquidation proceeds unless the agreements are entered into to circumvent the one-class-of-stock requirement. *Reg.* §1.1361-1(*l*)(2). Distributions, actual or constructive, that differ in timing or amount will be given appropriate tax effect, including whether they indirectly result in a prohibited second class of stock.

Contractual rights and obligations attendant to stock purchase agreements by an S corporation to redeem or purchase stock on death, divorce, disability, or termination of employment are generally disregarded in determining whether a corporation's shares confer identical rights. Forfeiture restrictions on nonvested stock under *IRC* §83 are also disregarded. *Reg.* §1.1361-1(*l*)(2)(iii)(B).

Similarly, rights and obligations created under typical buy-sell agreements, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights. Notwithstanding the foregoing, rights and obligations under buy-sell and similar agreements will result in a prohibited second class of stock when

> (1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and
>
> (2) The agreement establishes a [redemption or] purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market

value of the stock.

Reg. §1.1361-1(*l*)(2)(iii)(A). See §11.23.

The regulations treat options, warrants, and similar rights as a second class of stock if, taking into account all facts and circumstances, the subject right (1) is substantially certain to be exercised by the holder and has a strike or exercise price that is substantially below the fair market value of the underlying stock on the date that the call option or warrant is issued, (2) is transferred by an eligible shareholder of an S corporation to a person who is not eligible to own S stock, or (3) is materially modified. A call option, warrant, or similar right will not, however, be treated as a second class of stock if it is issued in connection with a loan to a person who is actively and regularly engaged in the business of lending and in connection with a loan that is commercially reasonable. A call option, warrant, or similar right also will not constitute a second class of stock if, on the date of issuance or the applicable testing date, the strike price of the right is not substantially below the fair market value of the underlying stock on that date. See *Reg.* §1.1361-1(*l*)(4)(iii).

The call option rules do not apply to call options or similar instruments that were issued before May 28, 1992, and that have not been materially modified. These options are subject to previously existing analysis that was much more favorable. Indeed, the Service's prior position was that an S corporation may retain its tax status even if it issues options, warrants, or certain debentures convertible into stock at a later time. See *Rev.Rul.* 67-269, 1967-2 C.B. 298, *obsoleted by Rev.Rul*. 95-71, 1995-2 C.B. 323; *Estate of Miller v. Commissioner*, 43 T.C. 760 (1965). Even grandfathered warrants, options, and convertible instruments must be used with caution, however, because the later exercise of the option or warrant may result in violation of the one-class-of-stock rule. See §11.25.

b. [§11.22] Voting Rights

IRC §1361(c)(4) permits differences in voting rights. Although the statutory language is not without ambiguity, under *Reg.* §1.1361-1(*l*)(1), an S corporation may have voting and nonvoting stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors. However, nonvoting stock is treated as stock for all other purposes in S corporations, including the consent to file the subchapter S election and the rules permitting termination by revocation of a majority of the stockholders. A voting trust also will not give rise to a second class of stock. See *IRC* §1361(c)(2)(A)(iv); *Reg.* §1.1361-1(h)(1)(v); *A & N Furniture & Appliance Co. v. United States*, 271 F.Supp. 40 (S.D. Ohio 1967); *Parker Oil Co. v. Commissioner*, 58 T.C. 985 (1972).

The fact that differences in voting rights are permitted provides flexibility in structuring management and voting control of an S corporation and will be of benefit for estate planning purposes. For example, in structuring a gift-giving program between family members of an S corporation engaged in an active trade or business, voting stock could be retained by the senior family members who actively operate the business, while nonvoting stock could be issued to the children. This would effectively split the corporation's income between the higher and lower tax bracket family members in proportion to stock ownership, subject to the government's ability to reallocate income for inadequate compensation for services or use of capital. See §11.87. This arrangement would also pass the future appreciation in the value of the gifted stock to the succeeding generation without estate or gift tax consequences to senior family members except to the extent a "string" type provision contained in *IRC* §§2036–2038 were to otherwise apply. See also *IRC* §2704.

c. [§11.23] Dividend Or Distribution Preferences

Unfortunately, S corporations may not issue any type or class of preferred stock. Preferences concerning the payment of dividends or liquidating distributions to shareholders will violate the one-class-of-stock rule. *Reg.* §1.1361-1(*l*)(1). This determination is based on a review of the corporate charter, bylaws, applicable state law, and binding agreements relating to distributions and liquidation proceeds, collectively referred to in the regulations as the "governing provisions." In contrast, other types of commercial transactions such as leases, employment agreements, and loans are not considered to be "governing provisions." However, the latter agreements, referred to as "commercial contractual agreements" under the regulations, can violate the one-class-of-stock rule when the agreements are designed to circumvent the one-class-of-stock requirement. *Reg.* §1.1361-1(*l*)(2)(i).

The prohibition on preferred stock may require that investors use a partnership or regular corporation in structuring business and investment ventures. For example, if investors placing funds into a venture require a priority distribution from available cash flow, such a provision in an S corporation would violate the one-class-of-stock rule. For this type of investor, only a pure creditor interest will be acceptable in providing for the portion of capital that is to receive a priority distribution.

Use of an S corporation may also not be as effective as a regular corporation or partnership in shifting future growth to a succeeding generation for estate planning purposes. This is because the tax planner cannot structure a direct "freeze" of senior family members' interests in an S corporation. In contrast, the use of a preferred partnership interest or preferred stock recapitalization may be designed to effectively "freeze" the value of equity interests retained by an older generation shareholder or partner in reducing the impact of federal estate taxes. These efforts are constrained by rules under Chapter 14 of the Code, most particularly in the context of preferred, frozen equity interests in a partnership or corporation. *IRC* §2701. See §7.8 of this manual.

Under *Reg.* §1.1361-1(*l*)(2)(iii)(A),

> Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—
>
> (1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and
>
> (2) The agreement establishes a [redemption or] purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

A purchase or redemption price set at "book value or at a price between fair market value and book value" will be acceptable. *Id.* In addition, "a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence." *Id*.

d. [§11.24] Disproportionate Distributions

An issue that remains uncertain is whether a non-pro rata distribution (not in redemption of stock) will be considered a distributional preference and violate the one-class-of-stock rule. This could arise by a dividend being paid only to certain shareholders, invariably violating corporate law requirements; indirectly, by payments of excessive compensation to a particular shareholder/employee; or by some other form of economic benefit not shared on a pro rata basis among all shareholders. Generally, the regulations provide that any distributions (actual, constructive, or deemed) that differ in timing or amount will not, per se, violate the one-class-of-stock limitation and are to be given appropriate tax effect in accordance with the facts and circumstances. *Reg.* §1.1361-1(*l*)(2)(i). *Reg.* §1.1361-1(*l*)(2)(vi) provides nine examples of the application of *Reg.* §§1.1361-1(*l*)(1)–(*l*)(2), which include imposition by state law of conditions that result in unequal distributions, treatment of distributions that differ in timing, excessive compensation, agreements concerning fringe benefits, other state law requirements, below-market loans to shareholders, and redemption agreements.

e. Debt Versus Equity

(1) [§11.25] In General

Debt issued by a corporation will not constitute a prohibited second class of stock unless (1) the debt constitutes equity under general principles of federal income taxation, and (2) a principal purpose of the arrangement is to circumvent the rights to distribution or liquidation proceeds or the eligibility limitations under subchapter S. *Reg.* §1.1361-1(*l*)(4)(ii)(A). Various factors used to determine whether purported debt is equity for federal income tax purposes include

- whether there was a written unconditional promise to pay with a fixed rate of interest;
- whether the obligation was subordinated to or preferred over other creditors;
- the ratio of debt to equity;
- whether the debt was convertible into stock; and
- the relationship between the holdings of stock in the corporation

and holdings of the interest in question.

When the debt is held proportionately by the shareholders in accordance with their percentage of stock ownership, a second class of stock will not be present even if the purported debt constitutes equity for other federal income tax purposes. *Reg.* §1.1361-1(*l*)(4)(ii)(B)(2).

Convertible debt exposes the corporation to greater risk of a second-class-of-stock issue. Under the regulations, convertible debt will be considered a second class of stock if (1) it constitutes equity for federal income tax purposes and a principal purpose of its issuance was to circumvent the limitations under subchapter S, or (2) it possesses rights equal to those of a call option that is substantially certain to be exercised and has a strike or conversion price substantially below the fair market value of the stock on the date of issuance, on transfer to an ineligible shareholder, or in the event of a material modification of the instrument.

(2) Straight Debt Instruments

(a) [§11.26] In General

A corporation may issue a "straight debt" instrument and avoid the second-class-of-stock issue. *IRC* §1361(c)(5)(A). This rule applies even if the debt instrument may be considered equity for other purposes, such as if debt repayments may result in dividend income. *Reg.* §1.1361-1(*l*)(5)(iv).

When straight debt is issued, no items of income, deduction, loss, or credit of the S corporation are allocable to the holders of the straight debt, although the same persons may also be shareholders and will receive allocations of tax items in that capacity.

A straight debt must be a written unconditional obligation to pay a sum certain in money on demand or on a specified date and

- the interest rate and payment date may not be contingent on profits, the debtor's discretion, or similar factors (although the interest rate may be dependent on the prime rate or a factor unrelated to the corporation);

- the instrument must not be convertible, directly or indirectly, into stock; and

- the creditor must be a person eligible to own stock in an S corporation or a person engaged in the lending business.

IRC §1361(c)(5)(B). A nonresident alien, corporation, or ineligible trust, for example, may not qualify as a holder of a straight debt instrument.

In contrast to an earlier version, the regulations recognize that the straight debt safe harbor does not specifically require that a "reasonable" interest rate be provided. However, the regulations do provide that, if the interest rate is too high, a portion of the interest may be treated as a payment that is not interest but would not result in a second class of stock. If the interest rate is too low, interest could be imputed depending on the context in which the loan was issued. See *IRC* §§483, 1272–1275, 7872. The amount of interest does not have to be fixed, provided it is not contingent on factors such as "profits, the borrower's discretion, or similar factors." *IRC* §1361(c)(5)(B)(i). It can be geared to the prime rate, Treasury bill rate, or other market index.

The regulations provide that unwritten advances from a shareholder are not treated as a second class of stock if the advances "do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time." *Reg.* §1.1361-1(*l*)(4)(ii)(B)(1).

(b) [§11.27] Instruments Not Qualifying As Straight Debt

Debt instruments that do not meet all requirements to be considered straight debt must be evaluated under the regulations and pertinent case law to assess the second-class-of-stock issue. Similarly, issuing debt to an ineligible shareholder or in a manner that does not meet the definition of straight debt requires the same careful scrutiny to ensure the tax status of an S corporation.

(c) [§11.28] Change In Status

Debt that constitutes straight debt on issuance may subsequently change into a non-straight debt instrument that might violate the one-class-of-stock rule. Under *Reg.* §1.1361-1(*l*)(5)(iii), an obligation that originally qualifies as straight debt ceases to so qualify if the obligation (1) is materially modified so that it no longer satisfies the definition of straight debt or (2) is transferred to a third party who is not an eligible shareholder. This may occur, for example, when prescribed payments of interest and principal under the note, which was a straight debt instrument at the time of issuance, are not timely made. Thus, it may be more advisable to urge shareholders in an S corporation to treat funds placed in operations as equity or stock contributions to reduce the risk of a second-class-of-stock problem or the risk of placing the corporation in a potential cash flow bind by requiring regular payments on shareholder debt.

The legislative history to SSRA provides that a regular or subchapter C corporation having preexisting debt qualifying as straight debt outstanding before it elects subchapter S status will not be treated as engaging in an exchange of debt for stock on filing an election. *Reg.* §1.1361-1(*l*)(5)(v) confirms this result. Conversion from C to S status will also not be treated as an exchange of debt for stock for federal income tax purposes. Repayments on this debt, however, may be treated as made with respect to stock for purposes of characterizing the repayment as an ordinary dividend.

(d) [§11.29] Practical Considerations

Straight debt is certainly preferable to other forms of shareholder or investor debt to ensure tax status as an S corporation. Certainty of tax status is an important, if not fundamental, requirement for investors in any business organization, so that they may properly project their tax obligations in the future and reduce their exposure to an unforeseen tax for previous events.

When the investors in an S corporation have different economic goals or are concerned about a priority recovery of funds invested in the corporation, use of a straight debt instrument may be desirable because dividend and liquidation preferences cannot otherwise be provided in issuing shares of stock or by shareholder agreement. Thus, for shareholders contributing different amounts of capital, straight debt instruments should be considered. When straight debt cannot be used (*e.g.*, the creditor is not eligible to own S stock), as many of the straight debt features should be incorporated within the instrument as possible. The risks of second-class-of-stock treatment become significant when the debt participates in profits or earnings through a rate kicker or the obligation is otherwise convertible into stock. Under certain circumstances, however, call options may be granted in connection with a loan determined to be commercially reasonable and made to a commercial lender who is actively and regularly engaged in the business of lending.

Even when the investors agree to provide funds to the corporation in proportion to their stock ownership and are not particularly concerned about an immediate withdrawal of their funds once the company becomes profitable, a long-term straight debt instrument may be beneficial. For example, if the corporation later revokes its subchapter S status and is converted into a regular or C corporation, the existence of debt may be a more effective means to withdraw previously invested capital without a double tax on corporate (post-S election) profits. Moreover, the presence of loans from shareholders on termination of the subchapter S election will be important for purposes of determining whether the payments of "interest" are deductible for federal income tax purposes.

B. Shareholders

1. [§11.30] In General

An S corporation may not have a shareholder other than an individual (but not a nonresident alien), an estate (including the estate of an individual in bankruptcy under Title 11 of the United States Code), a qualifying trust, or certain tax-exempt entities. *IRC* §§1361(b)(1)(B)–(b)(1)(C), (c)(6). This precludes a corporation, partnership, nonresident alien, or ineligible trust from being a shareholder in an S corporation. Ventures involving foreign investors, therefore, must be structured in partnership or LLC form, see §11.11, to provide for one level of tax on operations. In these partnerships, foreign persons are subject to withholding at the partnership level. See *IRC* §§1441, 1445.

Although an individual's estate may be an eligible shareholder, it is currently uncertain whether a nonresident alien's estate may own stock in an S corporation. This is due to a technical interpretation of *IRC* §1361(b)(1)(C), which prohibits an S corporation from having a nonresident alien shareholder. See *IRC* §7701(b). The legislative history provides that the rule against a nonresident alien shareholder applies only to individuals.

IRC §1361(c)(2)(A) expressly prohibits a foreign trust from owning stock in an S corporation. Specific insertion of this rule would not be required if a foreign trust was automatically deemed to be a nonresident alien for eligibility purposes. Despite this ambiguity, it should be anticipated that until the regulations are issued, the IRS will take a negative position on this issue.

Under the Small Business Job Protection Act of 1996, tax-exempt organizations described in *IRC* §§401(a) and 501(c)(3) are permissible shareholders. *IRC* §1361(c)(6). For purposes of counting shareholders, each tax-exempt organization holding S stock will be treated as a single shareholder. This amendment allows S corporations to establish employee stock ownership plans (ESOPs) to provide employee retirement incentives and permits S shareholders to make gifts of appreciated S stock to a public charity or private foundation.

2. Eligible Trusts

a. [§11.31] In General

There are seven types of trusts that may be shareholders in an S corporation. All other trusts, including foreign trusts, may not own stock in an S corporation. The seven types are as follows:

- Grantor trusts. A trust treated as owned by the grantor under *IRC* §§671–677, or owned by a person other than the grantor under *IRC* §678, is eligible to own stock in an S corporation if either the grantor or the other individual is an eligible shareholder (*i.e.*, a United States citizen or resident). The person deemed to be the owner of the trust, not the trust itself, is considered to be the shareholder for purposes of subchapter S. *IRC* §§1361(c)(2)(A)(i), (c)(2)(B)(i). An example of a grantor power is the power to revoke the trust when the grantor has a reversionary interest in either income or corpus that exceeds 5% of the income or corpus or the power to control the beneficial enjoyment of the trust. Another important requirement is that all of the trust, not just a portion, must be owned by the individual grantor.

- Grantor trusts after the death of the grantor. A grantor trust that owned stock in an S corporation trust may continue to be an eligible shareholder for two years after the death of the grantor or deemed owner. *IRC* §1361(c)(2)(A)(ii).

- Certain testamentary trusts. A trust to which stock in an S corporation is transferred under the terms of a will is an eligible shareholder for two years beginning with the date the stock is received by the trust. *IRC* §1361(c)(2)(A)(iii).

- Voting trusts. A voting trust does not constitute an ineligible shareholder, although each beneficiary is considered to be the shareholder of the S corporation for tax purposes, including eligibility to elect subchapter S. *IRC* §§1361(c)(2)(A)(iv), (c)(2)(B)(iv).

- Qualified subchapter S trusts. A qualified subchapter S trust (QSST) is also a permitted shareholder. The definition of a QSST is provided in *IRC* §1361(d), which sets forth specific requirements that must be met at all times. See §§11.34–11.39.

- Electing Small Business Trusts. Electing small business trusts (ESBTs) were authorized as permissible shareholders in subchapter S corporations by the Small Business Job Protection Act of 1996. *IRC* §1361(c)(2)(A)(v). The definition of an ESBT is provided in *IRC* §1361(e)(1).

- Individual retirement accounts if the corporation is a bank (as defined in *IRC* §581) or a depository institution holding company (as defined in §3(w)(1) of the Federal Deposit Insurance Act). *IRC* §1361(c)(2)(A)(vi). The amount treated as stock in this scenario equals only the amount of stock held by the trust as of October 22, 2004.

b. [§11.32] Estates

The estate of an individual, including an estate in a bankruptcy action under Title 11 of the United States Code, is permitted to be a shareholder in an S corporation. *IRC* §§1361(b)(1)(B), (c)(3). Although this facilitates the testamentary distribution of stock in an S corporation during probate administration, the period of estate administration should not be extended beyond a reasonable period of time, because regulations under subchapter J, governing the income taxation of estates and trusts, may convert the estate into a trust for federal income tax purposes. If this occurs, the trust may be ineligible to own stock in an S corporation, causing a termination of the election. See *Old Virginia Brick Co. v. Commissioner*, 367 F.2d 276 (4th Cir. 1966).

c. [§11.33] Estate Planning Considerations

Because of the limited ability of trusts to own stock in an S corporation, estate planners must be alert to eligibility issues when planning for the transfer of stock in a closely held S corporation to family members and in maintaining the election during probate administration. As stated in §11.32, protracted administration of an estate holding S stock may result in an inadvertent termination as a result of the estate's recharacterization as a trust for federal income tax purposes. *Reg.* §1.641(b)-3(a). See also *Rev.Rul.* 76-23, 1976-1 C.B. 264 (estate remaining open during period in which estate taxes are deferred under *IRC* §6166 will not result in estate becoming ineligible shareholder). Estate planners considering the use of inter vivos or testamentary trusts to pass stock in an S corporation to a succeeding generation should consider the use of a qualified subchapter S trust for achieving this purpose. See §§11.34–11.39.

3. Qualified Subchapter S Trusts

a. [§11.34] Requirements

In accordance with *IRC* §1361(d), a qualified subchapter S trust (QSST) must meet all of the following requirements:

- All of the trust income is distributed, or required to be distributed, currently to one individual who is a United States citizen or resident. *IRC* §1361(d)(3)(B). "Income," defined by reference to *IRC* §643(b), is the amount of income of the trust for the taxable year determined under the terms of the governing instrument and applicable local law and does not mean taxable income under the Code.

- There may be only one current income beneficiary. *IRC* §1361(d)(3)(A)(i). A substantially separate and independent share of the trust within the meaning of *IRC* §663(c) is treated as a separate trust for purposes of this rule. See *IRC* §1361(d)(3).

- Any corpus distributed during the life of the current income beneficiary must be distributed to that beneficiary. *IRC* §1361(d)(3)(A)(ii). This rule applies to all trust property, not just the S corporation stock. As an example, a trust that may expand for after-born grandchildren may not qualify as a QSST because a corpus distribution may go to a person other than the current income beneficiary. There must be a separate trust for each grandchild.

- Any income interest of a current income beneficiary must terminate on the earlier of the death of that person or the termination of the trust. *IRC* §1361(d)(3)(A)(iii). An income interest for a term of years may not qualify unless the trust will terminate at the end of the term.

- If the trust terminates during the life of the current income beneficiary, all trust assets must be distributed to that person. *IRC* §1361(d)(3)(A)(iv).

A QSST may hold stock in more than one S corporation. See *IRC* §1361(d)(2)(B)(i).

b. [§11.35] Election

The current income beneficiary of a QSST must make a timely election to qualify the trust. *IRC* §1361(d)(2). The election is subject to the following terms and conditions:

- A separate election must be made for each S corporation in which the QSST owns stock. *IRC* §1361(d)(2)(B)(i).

- Once made, the election is irrevocable unless consent is received from the IRS. *IRC* §1361(d)(2)(C). It is possible to have successive income beneficiaries in a QSST, and each successive beneficiary is deemed to have made the election unless he or she affirmatively refuses to consent within 75 days of becoming the income beneficiary. *IRC* §1361(d)(2)(B)(ii).

The possibility that there will be multiple income beneficiaries after the death of the current income beneficiary will not presently disqualify the QSST. When those succeeding interests vest in possession, however, the trust will lose its QSST status once there are multiple income beneficiaries, even if all other QSST requirements may be satisfied.

The election to be a QSST is separate from the subchapter S election itself. The QSST election must be made within 75 days of the later of the date stock is transferred to the trust or the first day of the first taxable year to which the subchapter S election applies. *IRC* §1361(d)(2)(D). The proper party for consenting to the QSST election is the beneficiary or that person's legal representative. *IRC* §1361(d)(2)(A). A separate election is required with respect to stock in each S corporation held by the trust. *IRC* §1361(d)(2)(B)(i).

c. [§11.36] Loss Of Eligibility

If a QSST later fails to meet all QSST requirements, it ceases to be an eligible shareholder as of that date. *IRC* §1361(d)(4). This, in turn, will terminate the corporation's subchapter S election as of that date unless the trust qualifies as another type of eligible trust. Amendments to trust instruments must be analyzed, therefore, to determine whether QSST status will be terminated or foreclosed in the future.

As previously discussed in §11.31 with respect to grantor and *IRC* §678 trusts, a trust that ceases to qualify as a QSST on the death of the deemed owner may nevertheless continue to be an eligible shareholder after the date of the income beneficiary's death by qualifying as an eligible trust under the other categories set forth in §11.31. For example, if all of the assets of the QSST are included in the income beneficiary's gross estate, the trust may remain a shareholder for a two-year period after the date of death of the income beneficiary.

d. [§11.37] Estate Planning Considerations

A QSST may qualify as a qualified terminable interest property (QTIP) trust under *IRC* §§2056(b)(7) and 2523(f) for purposes of federal estate and gift taxation. As a result, a QSST may become a useful estate planning tool. A QSST would also be a marital deduction trust under *IRC* §2056(b)(5), providing for all income to the surviving spouse for life with a power of appointment over the entire interest. On the other hand, if the surviving spouse has a lifetime general power of appointment in favor of others, the QSST requirement that the terms of the trust limit any distributions of corpus during the lifetime of the current income beneficiary to only that person will be violated.

A QSST can also be part of a trust for minor children, qualifying for the gift tax exclusion under *IRC* §§2503(b)–(c), provided that all income is required to be distributed annually or in fact is distributed annually to the income beneficiary. This income distribution requirement may be viewed, however, as inconsistent with the creation of the minor's trust in general. In any event, it must be understood that the QSST income beneficiary will be treated as the shareholder for pass-through purposes so that the reporting of the QSST's pro rata share of S corporation income will be reported on the income beneficiary's return with or without a corresponding distribution of cash or other property from the corporation.

e. [§11.38] Income Tax Considerations

IRC §1361(d)(1)(B) provides that the income beneficiary of a QSST will be treated as the owner of the subchapter S stock held by the trust. As a result, all tax items of the S corporation will be passed through directly to the beneficiary for reporting on his or her individual income tax return and not reported by the trust.

This could create a strain on the income beneficiary if income is retained by the corporation. The shareholders of the corporation could agree that, subject to state law limitations, the corporation must make annual distributions for years in which it files as an S corporation equal to the maximum federal rate of income tax times the corporation's taxable income. This would prevent a shareholder, including a QSST income beneficiary, from having to pay tax without cash. Consideration should also be given to allocating capital gains to income and not principal under the trust instrument so that the beneficiary may receive the proceeds of sale to pay income taxes.

In *Reg.* §1.1361-1(j)(8), effective for taxable years beginning after July 21, 1995, the amount received by a QSST on its deposit of S corporation stock is treated as received by the trust in its capacity as a separate taxpayer under subchapter J of the Code and not by the trust's income beneficiary. Under *Reg.* §1.1361-1(k)(2)(iii), when a QSST has sold or disposed of S corporation stock in a year that is open for both the QSST and income beneficiary (but on or before July 21, 1995), the QSST and the income beneficiary may elect to treat either the beneficiary or the QSST as the owner of the stock sold for the recognition of gain or loss as long as the

QSST and income beneficiary take consistent positions and report it on their respective returns. *Id.*

f. [§11.39] Overlap Between QSST And Grantor Trust Rules

There is a potential overlap between the rules on QSSTs and grantor trusts. In this event, the grantor trust provisions control. For example, if shares of stock in an S corporation are transferred in trust by a person treated under the grantor trust rules as the owner of the trust, the trust may not be a QSST with respect to that corporation. See *Reg.* §1.1361-1(h)(3).

g. Qualified Subchapter S Subsidiary

(1) [§11.40] In General

A Qualified Subchapter S Subsidiary (referred to here as "QSSS" but referred to under the Treasury Regulations as "QSubs") is any corporation that is not an ineligible S corporation under *IRC* §1361(b)(2) if it is wholly owned by an S corporation and the S corporation elects to treat such corporation as a QSSS. *IRC* §1361(b)(3)(B). The parent S corporation must own 100% of the QSSS's issued and outstanding stock. For federal tax purposes under Subchapter S, a QSSS "shall not be treated as a separate corporation," and "all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation." *IRC* §1361(b)(3)(A). If an S corporation makes a valid QSSS election of a subsidiary, "the subsidiary is deemed to have liquidated into the S corporation." *Reg.* §1.1361-4(a)(2). However, a QSSS "is treated as a separate corporation for purposes of Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code)." *Reg.* §1.1361-4(a)(7).

(2) [§11.41] Election And Revocation

Like the S corporation election for a new corporation, QSSS election is very important. The QSSS election may be made by the S corporation parent at any time during the taxable year, *Reg.* §1.1361-3(a)(3), and is made on Form 8869, available at www.irs.gov/pub/irs-pdf/f8869.pdf.

A QSub election will be effective on the date specified

> on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. . . . If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

Reg. §1.1361-3(a)(4). An extension of time to make the QSSS election may be available under *Reg.* §§301.9100-1 and 301.9100-3. *Reg.* §1.1361-3(a)(6).

A parent S corporation may revoke a QSSS election by filing a statement with the IRS service center where the parent's most recent return was correctly filed. The revocation statement must state the name, address, and taxpayer identification number of both the parent S corporation and the QSSS corporation. *Reg.* §1.1361-3(b). The revocation of the QSSS election is effective on the date specified on the revocation statement or when the revocation statement is filed if no date is specified. *Reg.* §1.1361-3(b)(2).

(3) [§11.42] Termination Of QSSS Election

The termination of a QSSS election is effective

- on the effective date contained in the revocation statement;
- at the close of the last day that the parent's S election terminates; or
- at the close of the day on which an event occurs that renders the subsidiary ineligible for QSSS status under IRC §1361(b)(3)(B), such as the parent ceasing to own 100% of the outstanding stock of the QSSS.

Reg. §1.1361-5(a).

If a QSSS ceases to meet the requirements of a QSSS, the corporation “shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before [the] cessation from the S corporation in exchange for its stock.” *IRC* §1361(b)(3)(C). If a corporation’s status as a QSSS terminates, that corporation and any successor are not eligible to make a QSSS election or S corporation election before the fifth taxable year beginning after the first taxable year for which the termination was effective, “unless the Secretary consents to such election.” *IRC* §1361(b)(3)(D).

C. Permitted Year

1. [§11.43] In General

Under *IRC* §1378(a), the taxable year for an S corporation is a “permitted year,” defined in *IRC* §1378(b) as either a calendar year or a different year for which the corporation satisfies the Service that there is an adequate business purpose.

Before SSRA, a subchapter S corporation was free to select any fiscal year regardless of the taxable years of its shareholders. This allowed shareholders to defer the reporting of undistributed income from S operations for up to 11 months (such as calendar year shareholders in a January 31 fiscal year S corporation). In enacting SSRA, Congress acknowledged that this deferral was an unintended tax benefit under the S rules as originally enacted. Still, a limited deferral of up to three months is permitted under *IRC* §444 provided that the corporation makes payments under *IRC* §7519.

2. Selection

a. [§11.44] Calendar Year

All S corporations may use a calendar year. The permitted year rule in *IRC* §1378 is not a condition for making the subchapter S election, but instead requires that the S corporation use a calendar or otherwise permitted year and allows the Service to impose this requirement. Previously, the adoption of, or change to, a permitted year was a requirement for making a valid subchapter S election or retaining the subchapter S election. Procedural rules for complying with the permitted year requirement are presently set forth in *Rev.Proc.* 2006-46, 2006-2 C.B. 859.

Corporations using a fiscal year that convert to subchapter S by filing an S election will generally be required to change to a calendar year or provide a satisfactory business purpose for continuation of the fiscal year. If all of the S corporation's principal shareholders have used or simultaneously changed to a calendar year, the corporation may change automatically to a calendar year. In addition, an S corporation (including a converting C corporation) may adopt, retain, or change to a fiscal year if the shareholders owning more than one half of the stock have or are concurrently changing to the same tax year. See §11.46. A shareholder may not change his or her taxable year, however, without first securing IRS approval under regulations to *IRC* §442. A principal shareholder is any shareholder owning 5% or more of the stock of the corporation. When an S corporation subsequently fails to meet the ownership test for a fiscal year, it must convert its tax year to a permitted year under *IRC* §1378.

b. Other Permitted Year

(1) [§11.45] Business Purpose

Under *IRC* §1378(b)(2), a year based on a "period for which the corporation establishes a business purpose to the satisfaction of the Secretary" may qualify as a permitted year. Deferral of income to the shareholders, however, is not a business purpose. But see *IRC* §444.

An S corporation may use the period ending with its natural business cycle as its permitted year. *Rev.Proc.* 2006-46, 2006-2 C.B. 859. The test required by this procedure may be satisfied by review of all facts and circumstances or by meeting a gross receipts test. The operation of a seasonal business may also fall within the scope of this rule. A natural business year will qualify as the permitted year if 25% or more of the corporation's gross receipts for a 12-month period are recognized during the last two months of the period and the requirement is met for the three consecutive 12-month periods ending with the last month of the required natural business year. *Id*. If the corporation wants to change its taxable year, it must obtain approval from the Commissioner. *Reg.* §1.1378-1.

Except as permitted under *IRC* §444, the deferral of income at the shareholder level is not a business purpose. Moreover, the legislative history to subchapter S indicates that certain nontax factors, such as use of a fiscal year for regulatory or financial accounting purposes, administrative functions or hiring patterns, or time for making pricing changes, ordinarily will not satisfy the business purpose requirement. This narrow interpretation rejecting matters of business convenience as business purpose has been endorsed by the Service in *Rev.Rul.* 87-57, 1987-2 C.B. 117. See H.R. Rep. No. 841, 99th Cong., 2d Sess. II-319 (1986).

(2) [§11.46] Shareholders' Tax Year

A corporation may adopt, retain, or change a fiscal year if persons owning more than one half of the stock use, or change to, the same fiscal year. Because nearly all individuals are calendar year taxpayers and all trusts are now required to use a calendar year as well, the possible use of the "majority shareholder" rule is, from a practical standpoint, limited to estates owning stock in S corporations. See *IRC* §644(a); *Rev.Proc.* 2006-46, 2006-2 C.B. 859.

(3) [§11.47] Limited Deferral

An S corporation may elect to use a fiscal year under *IRC* §444 provided it will not defer income at the shareholder level for more than three months. This election may be made only once and only if the corporation is not a member of a "tiered structure." It requires the corporation to make payments under *IRC* §7519 intended to eliminate the tax benefit of the deferral. The required payment is determined at a rate that is 1% greater than the maximum rate of tax on individuals. See IRS Announcement 94-5, 1994-2 I.R.B. 39. This increased rate presumably is required to offset the time-value benefit associated with the shareholders' deferral of making timely estimated tax payments. On the other hand, the computation of taxable income for purposes of the deferral is made without regard to the normal deduction limitations imposed on S corporation shareholders, such as the basis limitation, at-risk, and passive activity loss rules. The required payment is based on the corporation's taxable income for the preceding fiscal year. Therefore, in periods of increasing income, the use of *IRC* §444 may be of some benefit. This election may also be useful when the corporation historically receives a disproportionate amount of its income during the "deferral period" but otherwise cannot satisfy the "business purpose" fiscal year rule requirements under *Rev.Proc.* 2006-46, 2006-2 C.B. 859.

III. ELECTION PROCEDURES

A. Timing

1. [§11.48] In General

A corporation's subchapter S election must be filed either

- at any time during its taxable year immediately preceding the first taxable year for which the election is to be effective, or
- at any time during a portion of the first taxable year for which the election is to be effective that occurs before the 16th day of the third month of that year.

IRC §1362(b)(1). If the election is made at any time beginning after the 15th day of the third month of its taxable year (and before the 16th day of the third month of the following year), the election will be treated as effective for the following year, provided that the corporation meets all eligibility requirements on the date of filing, its effective date, and all subsequent dates. If the election is made on or before the 15th day of the third month of its taxable year, the election will be effective on the first day of the year, provided that the corporation met the eligibility requirements throughout, beginning on the first day of the tax year. *Reg.* §1.1362-6(a)(2)(ii)(B). The term "month" is defined as "a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the close of the last day of the succeeding calendar month." *Reg.* §1.1362-6(a)(2)(ii)(C).

The IRS may treat a late subchapter S election as timely if the Secretary determines that there was reasonable cause for the failure to make the election timely. *IRC* §1362(b)(5).

2. [§11.49] New Corporations

The application of the election rules to new corporations is important. The regulations liberally apply the 15th-day-of-the-third-month rule as, in effect, giving the corporation two calendar months and fifteen days in which to file the subchapter S election. As an example, if a corporation begins its first taxable year on March 7, it must make a subchapter S election on or before May 22 (15 days after May 7) for the election to be effective for its first taxable year. If the end of the 2-month-and-15-day election period ends on a Saturday, a Sunday, or a legal holiday, the filing period is extended to the next business day. See *Reg.* §301.7503-1(a).

A newly organized corporation must determine when its filing period begins to have its election effective for its first taxable year. The first taxable year of a new corporation begins when the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. *Reg.* §1.1362-6(a)(2)(ii)(C). This subchapter S election is made by completing Form 2553 and filing it with the designated Service Center. *Reg.* §1.1362-6(a)(2)(i).

State law considerations in this area are critical in determining the date the corporation "exists" and when it has shareholders. For example, an S election may not be filed if it is made before the effective date of the corporation's organization under state law. See *Frentz v. Commissioner*, 44 T.C. 485 (1965), *aff'd* 375 F.2d 662 (election filed before articles of incorporation were filed held invalid). See also *Ratcliff v. Commissioner*, ¶80,012 T.C.M. (P-H), 39 T.C.M. (CCH) 886 (1980), *aff'd* 636 F.2d 1203. Some states do not recognize or otherwise modify the applicable taxing regime to S corporations filing elections under the Code.

When establishing the date on which the corporation has shareholders, the date normally used will be the date the stock is issued. However, subscribers of stock at initial issue may be treated as shareholders for purposes of this rule if it can be established that they assumed the status of shareholder or otherwise acquired equitable title to the stock. *Bone v. Commissioner*, 52 T.C. 913 (1969); *Denemark v. Commissioner*, ¶76,267 T.C.M. (P-H), 35 T.C.M. (CCH) 1170 (1976). See also *Rev.Rul.* 72-257, 1972-1 C.B. 270 (period of election began to run on date of incorporation because subscribers were shareholders under state law); *Artukovich v. Commissioner*, 61 T.C. 100 (1973) (election considered too late because of acquisition of assets); *T.H. Campbell & Bros., Inc. v. Commissioner*, ¶75,149 T.C.M. (P-H), 34 T.C.M. (CCH) 695 (1975).

3. Current Year Effective Date

a. [§11.50] In General

If the corporation intends to file an election for its current taxable year, certain additional requirements must be met. The corporation must meet all eligibility requirements for each day during that taxable year, and all shareholders owning stock in the corporation on or before the date the election is filed during that taxable year must consent to the election. This includes shareholders who owned stock during this period but who were not shareholders on the date the election was filed. If these two requirements are not satisfied, the election will be effective for the succeeding taxable year, provided the corporation otherwise maintains eligibility. *IRC* §1362(b)(2); *Reg.* §1.1362-6(a)(2)(ii)(B).

If, for example, an existing corporation using a calendar year desires to elect S corporation status during 2009 and files its election on the last day for the period (March 15, 2009), the corporation must satisfy all requirements of an S corporation from January 1, 2009, to March 14, 2009, as well as on the date the election is filed (March 15, 2009). Moreover, all shareholders owning stock in the corporation at any time during this period must consent to the election. If, however, instead of March 15, the election was filed on or before, for example, January 5, 2009, only shareholders owning stock during that five-day period must consent to filing the election.

The shareholder consent requirement is designed to prevent the allocation of income or loss to a non-electing shareholder who either was ineligible to hold stock in an S corporation or did not consent to the election.

b. [§11.51] QSST

For a qualified subchapter S trust (QSST) to be an eligible shareholder, the beneficiary or legal representative must file a separate election for each S corporation in which the trust holds stock. In general, the QSST election must be filed within the 2-month-and-15-day period beginning on the date on which the stock of the corporation is initially transferred to the trust or within the 2-month-and-15-day period beginning on the first day of the first taxable year for which the subchapter S election is effective, whichever period occurs later. If stock of the corporation is transferred to the trust on or before the date an S election is filed, and if that election and transfer are made before the beginning of the first day of the first taxable year for which the S election is effective, the QSST election must be filed within the 2-month-and-15-day period beginning on the date on which the corporation makes the S election. *Reg.* §1.1361-1(j)(6).

4. [§11.52] Succeeding Year Effective Date

If an eligible corporation files an election on or before the 15th day of the third month of its current year, but fails to meet the eligibility requirements on one or more days before the date the election was filed, or if all shareholders owning stock in the corporation within the same period did not join in filing consents to the election, the election will be effective on the first day of the following taxable year. *IRC* §1362(b)(2).

All elections filed after the 2-month-and-15-day period will be effective for the succeeding taxable year. *IRC* §1362(b)(3).

B. Filing Requirements

1. [§11.53] In General

S corporation elections are made by filing IRS Form 2553, available at www.irs.gov/pub/irs-pdf/f2553.pdf. The form must be properly completed and signed by a corporate officer authorized to sign the corporation's informational return. Form 2553 must be filed with the service center designated in the instructions to Form 2553, available at www.irs.gov/pub/irs-pdf/f2553.pdf. *Reg.* §1.1362-6(a)(2)(i). Simply filing a subchapter S tax return with the Service is not a substitute for filing Form 2553, even if all other requirements under subchapter S are met.

The Service strictly interprets the procedural requirements for filing elections under subchapter S. Prudence dictates that proof be retained of timely filing by sending the corporate election by certified mail, return receipt requested, to establish the date of mailing as the date of filing. See *Trimarco v. United States*, 955 F.2d 45 (6th Cir. 1992) (IRS lost Form 2553). Compare *Brutsche v. Commissioner*, 585 F.2d 436 (10th Cir. 1978), with *Cabintaxi Corp. v. Commissioner*, 94,316 T.C.M. (RIA), 68 T.C.M. (CCH) 49 (1994), *aff'd in part, rev'd in part on other grounds* 63 F.3d 614. With only a few exceptions, taxpayers who have not used certified mail have failed to meet their required burden of proof for properly filing Form 2553. See *IRC* §7502 regarding mailing requirements.

Once made, the subchapter S election is effective for the applicable taxable year and for all succeeding taxable years of the corporation until the election is either terminated by failure to meet all eligibility requirements at all times (unless a waiver of an inadvertent termination is granted by the IRS under *IRC* §1362(f)), or revoked by action of the shareholders. *IRC* §§1362(c)–(d). See §§11.55–11.57.

2. [§11.54] Shareholder Consents

For the election to be effective, all persons who are shareholders of the corporation on the day on which the election is made must sign consents, either directly on Form 2553 or on a separate statement. If the election is made within the corporation's first taxable year and the election will be effective that year, each person who was a shareholder during that portion of the year preceding the election must also consent, whether or not that person is a shareholder at the time of the election. *Reg.* §1.1362-6(a)(2)(i). The information required is set forth on Form 2553 and in *Reg.* §1.1362-6(b)(3).

Although the corporation's election must be filed within two and one-half months of the beginning of its taxable year, it is possible for shareholders to file their consents after this period, provided reasonable cause is established to the satisfaction of the District Director or director of the service center in which the corporation files its income tax return that the interests of the government will not be jeopardized by treating the election as valid, and provided certain other procedural requirements are satisfied. See *Reg.* §1.1362-6(b)(3)(iii)(A). For example, an extension for filing shareholder consents may be granted when a corporation is required to have filed an election because it either acquired assets or began doing business, despite the fact that by the 15th day of the third month of its first taxable year it did not yet have shareholders or a shareholder was unavailable to consent. See *Calhoun v. United States*, 370 F.Supp. 434 (W.D. Va. 1973) (corporation required to file timely election even though there were no shareholders to consent). See also *Hicks Nurseries, Inc. v. Commissioner*, 62 T.C. 138 (1974), *rev'd on other grounds* 517 F.2d 437. Litigation is generally not required when satisfactory grounds are given to the Service. See *Rev.Rul.* 92-82, 1992-2 C.B. 238; *Priv.Ltr.Rul.* 9447022.

IV. TERMINATION OF ELECTION

A. Events Triggering Termination

1. [§11.55] Ceasing To Qualify As S Corporation

A corporation's subchapter S status terminates when it no longer meets all the requirements for a small business corporation under *IRC* §1361(b). *IRC* §1362(d)(2)(A). A termination will occur, for example, when stock in an S corporation is sold to an ineligible shareholder, such as a nonresident alien. See *IRC* §1361. Another common termination event is the transfer of stock to an ineligible trust.

A termination is effective as of the date of the terminating event. *IRC* §1362(d)(2)(B); *Reg.* §1.1362-2(b)(2). Unless the termination occurs on the first day of the taxable year, the "S termination year" taxable year of the corporation is divided into a qualifying period ("S short year") and a nonqualifying period ("C short year"). *IRC* §1362(e)(1); *Reg.* §1.1362-3(a). See §11.62.

2. Revocation By Shareholders

a. [§11.56] In General

A subchapter S election may be terminated voluntarily on the filing of consents of shareholders owning (or treated as beneficially owning under subchapter S) more than one half of the shares of stock of the corporation at the time the revocation is made. For this purpose, stock includes the shares of all shareholders, even nonvoting shareholders. As discussed below, the date that the revocation is filed is not necessarily the date the revocation is to become effective. *IRC* §§1362(d)(1)(A)–(d)(1)(B), (d)(1)(D).

Shares of stock filing consents, including both voting and nonvoting stock, must be aggregated and are not voted by class. *Reg.* §1.1362-6(a)(3). Accordingly, setting up the capital structure of an S corporation with voting and nonvoting stock should be made with an awareness that the holders of the nonvoting stock, if a majority of all issued shares, may break the subchapter S election. Still, this does not prevent the owners from entering into certain covenants and restrictions on the filing of a revocation.

The revocation is made by the corporation in the same manner as the filing of an election. The necessary shareholder consents must be attached to the revocation.

Subject to the rule discussed below concerning revocations containing a specific prospective date for termination, if the revocation is made on or before the 15th day of the third month of the corporation's taxable year, it will be effective retroactive to the first day of the period. *IRC* §1362(d)(1)(C)(i). A revocation made during the taxable year but after the 15th day of the third month is effective as of the first day of the following taxable year. *IRC* §1362(d)(1)(C)(ii). See *Reg.* §1.1362-2(a)(2)(i).

A revocation may specify a prospective date, including the date on which the revocation is filed, for terminating the election. *IRC* §1362(d)(1)(D). *Reg.* §1.1362-2(a)(2)(ii) states that a revocation specifying a prospective date will be effective only if the prospective revocation date is expressed in terms of a stated day, month, and year rather than in terms of a particular event.

A revocation may be rescinded at any time before it becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which rescission is made. *Reg.* §1.1362-2(a)(4).

b. [§11.57] Nonconsent By Succeeding QSST Beneficiary

A succeeding income beneficiary under a QSST may affirmatively refuse to consent to the previous income beneficiary's election. *IRC* §1361(d)(2)(B)(ii). This affirmative refusal must be filed within 60 days after the succeeding income beneficiary attains that status and must be filed in the manner set forth by *IRC* §1361(d)(2)(B)(iii). This unilateral act by a succeeding beneficiary will terminate the subchapter S election notwithstanding that shares held by the trust do not represent more than one half of the outstanding shares of stock in the corporation. Efforts to prevent this from occurring (*e.g.*, inserting in the trust instrument a clause prohibiting the succeeding income beneficiary from terminating a previously filed QSST election) are of uncertain effect. See §11.35.

3. Receipt Of Passive Investment Income

a. [§11.58] In General

Before SSRA, an S corporation's election was revoked retroactively as of the first day of the year, if during that year it derived greater than 20% of its gross receipts in the form of passive income, such as interest, dividends, rents, and royalties. Former *IRC* §1372(e)(5). This effectively prohibited S corporations from leasing real property for investment purposes. Under SSRA, this rule has been substantially modified, and newly electing S corporations will not be subject, in most cases, to any passive income restrictions. Thus, *new* S corporations may receive 100% of their gross receipts in the form of interest, dividends, or other passive sources, and yet maintain S status.

For taxable years beginning after 1981, a subchapter S election will be terminated for corporations that were formerly subchapter C corporations

- that have accumulated earnings and profits at the close of each of three consecutive taxable years, and
- for which more than 25% of their gross receipts for each of those three consecutive years constituted passive investment income.

IRC §1362(d)(3)(A)(i); *Reg.* §1.1362-2(c)(1). A termination for passive investment income will be effective as of the first day of the following taxable year beginning after the third consecutive taxable year referred to in *IRC* §1362(d)(3)(A)(i). *IRC* §1362(d)(3)(A)(ii).

As discussed in §11.99, it is possible, in accordance with *IRC* §1368(e)(3), for an S corporation and its shareholders to consent to treat distributions made with respect to stock as first coming out of earnings and profits (both C and S earnings and profits) instead of the accumulated adjustments account or "AAA" (defined in §11.94). *Reg.* §1.1368-1(f)(2). Absent the making of this special election, known as an "AAA bypass election," the AAA must be distributed before the corporation is deemed to distribute its earnings and profits. *IRC* §1368(c)(1). This allows shareholders in the corporation to avoid a termination or a corporate-level tax on excess net passive investment income under *IRC* §1375 by distributing all of the corporation's accumulated earnings and profits before the close of the particular S year. Under the regulations, a "deemed dividend" election may be made to distribute all or part of the corporation's accumulated earnings and profits. The deemed distribution does not require the distribution of cash or other property. *Reg.* §1.1368-1(f)(3). The application of this election becomes more complex for corporations that converted to S status or otherwise had S years before 1983. See *Reg.* §1.1368-1(f)(4). See also §11.108.

The election to make an AAA bypass election or deemed dividend must be made by attachment on a timely filed original or amended return. The regulations set forth what is required to be disclosed on the attachment. *Reg.* §1.1368-1(f)(5). Once made, the election is irrevocable.

Because there is no statute of limitations on the computation of earnings and profits, extreme care must be exercised in determining whether accumulated earnings and profits are present. This determination must also be made for earnings and profits adjustments required under *IRC* §§312 and 1368, and a full review should be undertaken of certain corporate-level transactions that, on audit, may result in attributing additional earnings and profits to prior C years. This could occur, for example, in a deferred like-kind exchange transaction involving an escrow account. If the transaction is collapsed and held to be taxable in the year of sale when the corporation was not an S corporation, accumulated earnings and profits would be generated in that year and not in the year that the escrow is applied in acquiring new property.

Under *IRC* §1362(f), the IRS is permitted to waive an inadvertent termination. This may occur if a corporation violates the passive investment income rules because it had determined in good faith, albeit erroneously, that it did not have any accumulated earnings and profits.

b. [§11.59] Passive Investment Income Defined

Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities (but only to the extent of gain). *IRC* §§1362(d)(3)(B)–(d)(3)(C)(i).

Passive investment income does not include the following:

- Interest on installment obligations from the sale of property in the ordinary course of a corporation's trade or business. An S corporation dealing in the sale of real estate lots or the sale of inventory on the installment method, therefore, would not derive passive investment income on its receivables. *IRC* §1362(d)(3)(C)(ii).

- Gross receipts "derived directly from the active and regular conduct of a lending or finance business." *IRC* §1362(d)(3)(C)(iii).

- Dividends from an affiliated C corporation in which the S corporation owns at least 80 percent of the total voting power and total value of the stock in the C corporation, to the extent those dividends are attributable to the C corporation's earnings and profits derived from the active conduct of a trade or business. *IRC* §§1362(d)(3)(C)(iv), 1504(a)(2).

- Rent received for the use or occupancy of rooms or other space when the corporation does not provide significant services or incurs substantial costs in the conduct of an active rental business. *Reg.* §1.1362-2(c)(5)(ii)(B)(2). Before the issuance of the revised final regulations, the former regulations provided that rents would generally be considered passive investment income even if significant services were provided, unless the significant services were not customarily rendered for leases of that type. Court decisions under the former, more restrictive standard were generally unfavorable. Compare *Bramlette Building Corp. v. Commissioner*, 52 T.C. 200 (1969), *aff'd* 424 F.2d 751, and *McIlhinney v. Commissioner*, ¶79,473 T.C.M. (P-H), 39 T.C.M. (CCH) 554 (1979), with *Nigh v. Commissioner*, ¶90,349 T.C.M. (P-H), 60 T.C.M. (CCH) 91 (1990).

- Copyright royalties and mineral, oil, and gas royalties, if the income from the royalties would not be personal holding company income under *IRC* §§543(a)(3)–(a)(4). The term "royalties" does not include royalties received in the ordinary course of business of licensing property, such as when the corporation created the property being licensed, performed significant services, or incurred substantial costs in connection with the development and marketing of the property being licensed. See *Reg.* §1.1362-2(c)(5)(ii)(A). Another exception applies to royalties received from the conduct of an active business computer software operation.

The threshold for passive investment income for terminations under *IRC* §1362 and tax under *IRC* §1375 is met when the gross receipts (not gross income) from passive sources exceed 25% of the corporation's total gross receipts for the taxable year. Gross receipts from the sale or exchange of capital assets (other than stocks and securities) are included only to the extent of the net capital gain. *IRC* §1362(d)(3)(B). This prevents a corporation from churning capital asset sales to artificially inflate gross receipts and avoid a termination or sting tax on passive investment income.

c. [§11.60] Passive Investment Income Tax

Even though a corporation will not lose its subchapter S election unless it has three consecutive years of passive investment income and accumulated earnings and profits, the presence of both factors in any single taxable year will expose the corporation to the corporate-level tax on its excess net passive investment income imposed at the highest corporate marginal rate, which for tax year 2013 is 34% on taxable income up to $10 million, and 35% on taxable income in excess of that amount, plus additional corporate incremental taxes of up to $100,000 (see *IRC* §11(b) flush paragraph). When a corporation's taxable income exceeds $15 million, the benefit of the 34% rate on the first $10 million in taxable income would be recaptured. *IRC* §11. See §§11.108–11.111 for further discussion.

d. [§11.61] Practical Considerations

Because S corporations having excess passive investment income face the twin perils of a termination of their status or a sting tax, or both, a corporation with prior subchapter C earnings and profits may be better advised not to elect subchapter S status, even if that would subject the corporation to a personal holding company tax or accumulated earnings tax because of the preponderance of its passive investment income or extent of subchapter C earnings and profits. Resolution of this issue should include consideration of the net-after-tax impact of distributing corporate-level earnings to the shareholders by comparing the personal holding company accumulated earnings and regular tax provisions for C corporations with the special corporate-level sting tax for S corporations under *IRC* §1375 and shareholder-level tax on the pass-through of income (net after the sting tax).

B. Termination Year Tax

1. [§11.62] Defined

If a termination is effective as of the first day of the taxable year, the corporation will be taxed as a regular or C corporation for the entire taxable year and all succeeding years until a new election is made. This could occur as a result of a revocation that is filed within the first two months and 15 days of the current taxable year. In that event, the revocation is retroactively effective to the first day of the taxable year unless a different date is specified with the revocation.

Complications arise, however, when the S election terminates on any day other than the first day of the corporation's taxable year. In this event, the corporation's entire taxable year is considered an "S termination year." *IRC* §1362(e)(4). An S termination year is composed of

- an "S short year," during which the corporation retains its subchapter S status from the beginning of that year through the day before the date of the terminating event, *IRC* §1362(e)(1)(A); and

- a "C short year," which is the balance of the S termination year ending on the last day of the corporation's taxable year, *IRC* §1362(e)(1)(B).

2. Allocation Of Tax Items

a. [§11.63] In General

The corporation's tax items (*e.g.*, income, loss, deduction, credit) for an S termination year must be allocated between the S short year and the C short year. There are two methods by which the allocation may be made:

- Pro rata allocation. This is based on the number of days in the S short year in relation to the entire taxable year (S termination year). *IRC* §1362(e)(2).

- Closing of books allocation. This is based on a hypothetical close of the books of the corporation as of the end of the S short year. If the corporation, all persons who were shareholders at any time during this period, and all persons who are shareholders on the first day of the C short year file consent, the allocation may be made on the basis of a hypothetical closing of the corporation's books as of the end of the S short year. *IRC* §1362(e)(3); *Reg.* §1.1362-3(b)(1). The election is made by filing a statement with the IRS. *Reg.* §1.1362-6(a)(5). When the closing of the books allocation election is made, the income or loss actually realized during the C short year will be allocated solely to the C short year. This tax is computed on an annualized basis under *IRC* §443. *IRC* §1362(e)(5).

The general rule of the pro rata allocation of tax items as of the date of termination cannot be made if there is a sale or exchange of 50% or more of the stock in the corporation or if the S corporation is acquired by a purchasing corporation in a transaction described under *IRC* §338. See *IRC* §§1362(e)(6)(C)–(e)(6)(D). In these situations, the allocations are made only for the period ending with the S short year based on a hypothetical closing of the books and records. *Reg.* §§1.1362-3(b)(1)–(b)(3).

b. [§11.64] Time To Select Allocation Method

If an allocation based on a hypothetical closing of the corporation's books is available, a final decision on filing the necessary consents may be deferred until the filing date for the corporation's S short year return — the same date as for filing the C short year return. *IRC* §1362(e)(6)(B); *Reg.* §1.1362-3(c)(2). If the corporation, for example, incurs substantial tax losses after the date of termination, the pro rata method may be favored by the shareholders because a portion of this loss could be shifted to the S short year and claimed on their returns. If consents were not filed, the losses would be trapped at the corporate level. Consideration should also be given to the fact that the corporate income tax for the C short year is determined on an annualized basis, which may increase the marginal rate of corporate tax on the income derived for the C short year. If a pro rata allocation is made, corporate-level taxes imposed during the C short year will also be allocated to the shareholders for the S short year. The S short year and the C short year are not treated as separate years for carry-back or carry-forward purposes. *IRC* §1362(e)(6)(A). See *Reg.* §1.1362-3(c)(4). But see *IRC* §1371(b)(3).

3. [§11.65] Filing Returns In S Termination Year

The corporation files two income tax returns in an S termination year: one for the S short year and the other for the C short year. The due date for filing both returns is the 15th day of the third month after the end of the subchapter S termination year, plus the time period permitted by proper extensions. *IRC* §§1362(e)(6)(B), 6037(a), 6072(b). Because the election and shareholder consents to assign tax items in a subchapter S termination year based on a hypothetical closing of the books do not have to be made until the filing of the return for the S short year, a final decision on this election can be deferred until all taxable events have been reported. Even if this decision is postponed, however, the election must be consented to by all shareholders owning stock during the S short year and on the first day of the C short year.

4. [§11.66] Reporting By Shareholders

Each shareholder must include in taxable income his or her pro rata share of the tax items described in *IRC* §1366(a) for the short year for the taxable year with which or within which the S termination year ends. *Reg.* §1.1362-3(c)(6). This will apply under either the pro rata allocation or closing of the books allocation of tax items for the S termination year.

5. [§11.67] Practical Considerations

It is important to consider the impact of the allocation rules for an S termination year in structuring or planning transactions that will terminate an S election (such as sale of stock to a corporation, nonresident alien, or ineligible trust). In a closely held corporation with related shareholders, it may be preferable to wait until the end of the taxable year to determine whether to make the election. On the other hand, in an arm's-length transaction, existing S shareholders may prefer to lock in the tax results attributable to their ownership of the stock through the end of the S short year without regard to subsequent events occurring during the balance of the subchapter S termination year. In this situation, the election to close books and records should be made and confirmed in the contract of sale.

C. [§11.68] Waiver Of Inadvertent Termination

As part of the overall reforms introduced by SSRA, *IRC* §1362(f) provides that the Service may waive an inadvertent termination of an S election if all four of the following conditions are satisfied:

- The election was terminated because the corporation either ceased to meet the definition of a small business corporation or had excess passive investment income (three-consecutive-year rule).

- The IRS determines that the termination was inadvertent, rather than intentional or voluntary.

- Within a reasonable period of time after the corporation or its shareholders discover the terminating event, steps are taken so that the corporation could regain eligibility.

- The corporation and all shareholders during the affected period agree to make adjustments consistent with the treatment of the corporation as an S corporation for the entire period. Certain adjustments will be required, for example, when a corporation had determined, erroneously but in good faith, that it did not have accumulated earnings and profits for three consecutive years in which it also had excess passive investment income. Under *IRC* §1362(d)(3), the presence of both factors results in the termination of the S corporation status as of the first day of the subsequent year. See also *Reg.* §§1.1362-4(a)–(f). A waiver may be granted on subsequent discovery of this miscalculation, provided the shareholders agree to include in gross income the revised computation of accumulated earnings and profits as taxable dividends.

D. [§11.69] Election After Termination

Once a corporation's subchapter S election is terminated, it (or any successor corporation, see *Reg.* §1.1362-5(b)) may not make a subsequent election for five taxable years, including the year of the termination, without the consent of the Secretary. *IRC* §1362(g). Consent generally will be granted if there is more than a 50% change in ownership since the year of termination. If there has not been a greater than 50% change in ownership, consent ordinarily will be denied unless it is shown that the event causing termination was not reasonably within the control of the corporation or of the shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or those shareholders to terminate the election. See *Reg.* §1.1362-5(a). However, if the corporation

> (1) Revoked its election effective on the first day of the first taxable year for which its election was to be effective . . . ; or
>
> (2) Failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election was to be effective . . . ,

it will be granted automatic consent to make a new election before the five year period has expired. *Reg.* §1.1362-5(c).

V. EFFECT OF ELECTION ON CORPORATION

A. Income Tax

1. [§11.70] Federal Tax Purposes

An S corporation will generally not be subject to federal tax on its income. A regular or C corporation, however, is subject to a corporate income tax or, if greater, a tax on its alternative minimum taxable income, generally tax preference and similar items, and a possible additional tax on undistributed accumulated earnings or undistributed personal holding company income.

An S corporation may be subject to a corporate-level tax if it realizes certain built-in gains after a subchapter C to S conversion (see §§11.105–11.107) or has excess passive investment income and subchapter C earnings and profits for the same year (see §11.108). In addition, the special corporate-level preference could apply under *IRC* §291 for the first three years after a C to S conversion. See *IRC* §1363(b)(4). Finally, corporate-level tax is triggered on a conversion from C to S status to the extent of the corporation's LIFO recapture amount (see §11.112), as that amount is determined under *IRC* §1363(d). Payment of the LIFO recapture tax is staggered over a four-year period beginning with the year in which the conversion from C to S occurs. Of course, termination of an S election will result in the corporation being taxed as a regular corporation.

2. [§11.71] Florida Tax Purposes

Under Florida law, an S corporation is not subject to the state income tax imposed on regular or C corporations by *F.S.* Chapter 220. An S corporation in Florida is not required to file a Florida corporate income tax return unless it has income subject to tax at the corporate level under the federal subchapter S provisions, such as for certain built-in capital gains. Reference in the Florida Statutes to the Code for this purpose has not been revised to reflect subchapter S after SSRA, however. Accordingly, it should be anticipated that an S corporation subject to a passive investment income tax under *IRC* §1375 will also be subject to the Florida corporate tax on the basis that the income is subject to tax at the corporate level. See *F.S.* 220.13(2)(i).

3. [§11.72] Other States

For S corporations doing business in states other than Florida, the tax impact of their laws on S corporations must be evaluated. State income taxation of S corporations is generally plagued by complexity, unfairness, and inconsistency. Many states do not permit a corporation and its shareholders to elect subchapter S treatment for state income tax purposes. Other states recognize an S election but impose different eligibility requirements than those under federal law. Finally, certain states recognize an S election but modify the manner in which the corporation and shareholders are taxed.

B. [§11.73] Computation Of Taxable Income

The taxable income of an S corporation is computed in the same manner as that of an individual, with the following exceptions:

- The amount and character of each item of the corporation's income, deductions, and credits, and any other item that could affect the tax liability of any shareholder, will "pass through" to the shareholders for reporting on their individual returns. *IRC* §1363(b)(1). For example, the amount of an S corporation's *IRC* §1231 gains and losses will be stated separately, and each will be passed through to the shareholders to be combined with their other *IRC* §1231 gains and losses.

- The depletion deduction, and deductions for personal exemptions, charitable contributions, net operating losses, and additional itemized deductions for individuals, are not allowed. *IRC* §1363(b)(2). If, however, the S corporation had incurred any of these items, each would be separately stated and passed through to the shareholders.

- Organizational expenditures may be amortized over a 180-month period, as provided by *IRC* §248. *IRC* §1363(b)(3).

- Tax preference items will apply as for a regular corporation under *IRC* §291 if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years. *IRC* §1363(b)(4).

- Investment income and investment expenses pass through to the shareholders under *IRC* §1366(a)(1) and are subject to the limitations imposed by *IRC* §163(d) on investment interest.

C. [§11.74] Tax Election

All tax elections generally will be made by the corporation, *IRC* §1363(c)(1), including selection of a tax year (subject to the permitted year rule discussed in §11.43), method of accounting, and election to opt out of installment sale treatment. *IRC* 1363(c)(2) lists two situations in which each shareholder must make, individually and separately, the appropriate election:

- Credit or deduction of foreign taxes paid or incurred during the taxable year under *IRC* §901.

- Deduction and recapture of certain mining exploration expenditures under *IRC* §617.

D. [§11.75] Distributions Of Appreciated Property

To the extent not inconsistent with the provisions of subchapter S, the rules of subchapter C apply to S corporations and their shareholders. *IRC* §1371(a). Liquidating and nonliquidating distributions of appreciated property to shareholders, therefore, are treated as recognition events at the corporate level, and the corporation is treated as if it had sold the appreciated property at its fair market value. This deemed sale may trigger the built-in gains tax under *IRC* §1374. This provision prevents shareholders from receiving a stepped-up basis in appreciated property without corporate-level recognition of the unrealized appreciation in the property. See §§11.101–11.102 for further discussion.

E. [§11.76] Integration With Subchapter C

Subchapter S does not provide the entire set of rules governing S corporations. *IRC* §1371(a) states that the provisions of subchapter C, *IRC* §§301–385, continue to apply to S corporations except as specifically provided in subchapter S or when inconsistent with the treatment of an S corporation as a conduit for tax purposes. The tax consequences of redemptions, distributions, liquidations, reorganizations, and other events, therefore, can be determined only by reference to both sets of provisions.

The Small Business Job Protection Act of 1996 repealed *IRC* §1371(a)(2), which treated an S corporation in its capacity as a shareholder of another corporation as an individual.

Because the issues raised in this area are extremely complex and also require a detailed understanding of subchapter C, the integration of subchapters S and C is beyond the scope of these materials. A detailed discussion of some of the problems faced in this area can be found in August, *Mergers And Acquisitions Of S Corporations—Part 1*, 9 No. 2 Bus.Ent. 6 (March/April 2007); *Mergers And Acquisitions Of S Corporations—Part 2*, 9 No. 3 Bus.Ent. 18 (May/June 2007); *Mergers And Acquisitions Of S Corporations—Part 3*, 9 No. 6 Bus.Ent. 6 (Nov./Dec. 2007).

F. [§11.77] Carry-Overs

There are restrictions on the ability to "carry forward" or "carry back" tax items between years in which the corporation was a C corporation and those in which it was an S corporation:

- No tax item arising during a taxable year in which a corporation was a regular or C corporation may be carried over to a taxable year in which the same corporation is an S corporation. *IRC* §1371(b)(1). For example, if a C corporation has net operating losses or unused business tax credits from prior years and then elects subchapter S status, these losses or credits may not be used by the S corporation in reducing the tax liability of its shareholders. The losses or credits, however, may be carried forward in the manner prescribed by law for use if and when the S election is terminated.

- During the time a corporation is an S corporation, no carry-forward or carry-back of any kind may be considered to have arisen at the corporate level. Thus, there is no carry-over of any kind from an S year to a C year. *IRC* §1371(b)(2).

- Notwithstanding the restrictions on carry-overs described above, the taxable year for which a corporation is an S corporation is still counted as a full year in determining the number of taxable years to which an item may be carried over. *IRC* §1371(b)(3).

VI. EFFECT OF ELECTION ON SHAREHOLDERS

A. Pass-Through Rules

1. [§11.78] In General

In an effort to achieve parity with the partnership rules under subchapter K, which will also apply to properly structured limited liability companies, the Code generally treats an S corporation as a conduit in passing through each item of corporate-level income, deduction, loss, or credit to its shareholders. These items are allocated in proportion to stock ownership based on all issued and outstanding shares, whether voting or nonvoting. *IRC* §1366. The beneficial owner of the stock, not a nominee or custodian, is the shareholder for this purpose. The allocation is made based on the number of days a shareholder owned a certain percentage of stock during the entire taxable year. *IRC* §1377(a)(1).

There are generally two classes of tax items: separately computed income or loss and nonseparately computed income or loss. *IRC* §1366(a)(1). Each tax item of the corporation, the separate treatment of which could affect the tax liability of any single shareholder, must be stated separately. *IRC* §1366(a)(1)(A). All other tax items are nonseparately computed and passed through in an aggregate amount to the shareholders. *IRC* §§1366(a)(1)(B), (a)(2).

Examples of separately computed tax items include

- capital gains and losses;
- *IRC* §1231 gains and losses;
- charitable contributions;
- tax-exempt interest;
- foreign taxes;
- investment interest and expenses; and
- depreciation and depletion.

2. [§11.79] Reduction For Corporate Taxes

If an S corporation incurs a corporate-level tax on passive investment income under *IRC* §1375, the gross amount of the item generating the gain is reduced by the amount of tax attributable to that item, and the net amount is passed through to the shareholders. *IRC* §1366(f)(3); *Reg.* §1.1375-1(e). If the corporation is subject to the built-in gains tax under *IRC* §1374, each item of built-in gain is reduced by a loss of the same character for the amount of the tax at the corporate level. The net amount of the gain is then passed through to the shareholders. *IRC* §1366(f)(2). Gain that is subject to tax under *IRC* §1374 is excluded from the definition of passive investment income under *IRC* §1375. *IRC* §1375(b)(4).

3. [§11.80] Character Of Tax Items

The character of each separately computed tax item is generally passed through to the shareholders in proportion to their stock ownership for reporting on their individual returns. *IRC* §§1366(a)–(b); but see *IRC* §1366(f)(2), mentioned in §11.79. An S corporation receiving tax-exempt interest income, for example, will pass it through to the shareholders. The conduit rules enacted under SSRA reflect a substantial change from prior law, when only a limited pass-through for long-term capital gain was available. All other income was passed through as dividend income or ordinary loss. Capital losses did not pass through to the shareholders and could be carried forward for five years.

IRC §1366(b) provides that the character of a tax item reported at the shareholder level "shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." This provision is susceptible of two interpretations having opposite results.

On one hand, it could be interpreted as requiring characterization of tax items solely at the corporate level. In this event, dealer status of a shareholder would not influence the pass-through of corporate-level gain.

On the other hand, if each shareholder, rather than the corporation, is deemed to have engaged in the sale proportionate to stock ownership, it is clear that this aggregate approach would result in ordinary income to a dealer/shareholder. This issue was clarified in *Reg.* §1.1366-1(b)(1), which provides that the character is determined at the corporation level and retains that character in the hands of the shareholder. Therefore, if an S corporation has capital gain, that gain will be characterized as capital gain regardless of whether the shareholder is a director.

B. Stock Basis

1. [§11.81] In General

Each shareholder has a basis in stock in the corporation that initially consists of that person's equity investment. For example, when a shareholder purchases S stock from another shareholder, his or her basis in the purchased shares will initially equal the purchase price for the stock. Under the subchapter S regime, this investment in stock or "stock basis" is adjusted for each individual shareholder's pro rata portion of tax items incurred by the corporation, and is reduced for distributions received from the corporation. *IRC* §1367. An S shareholder's stock basis, as adjusted, is used for determining gain or loss on a sale or redemption of stock and also serves as a limitation on the amount of losses that may be deducted by a shareholder for S operations during a particular taxable year. *IRC* §1366(d).

2. [§11.82] Adjustments

A subchapter S shareholder's stock basis is increased by the sum of

- additional capital invested in the corporation, *Reg.* §1.118-1;

- items of income separately stated and passed through for reporting on the shareholder's return, *IRC* §1367(a)(1)(A);

- nonseparately computed income that is passed through and reported on the shareholder's return, *IRC* §1367(a)(1)(B); and

- the excess of deductions for depletion over the basis of property subject to depletion, *IRC* §1367(a)(1)(C).

See also *Reg.* §§1.1367-1(b)(1)–(b)(2).

Shareholders in an S corporation may increase basis on the pass-through of separately or nonseparately computed income only to the extent those amounts were included previously in gross income on their return. *IRC* §1367(b)(1). These amounts may be increased or decreased to reflect the results of an audit or other final determination of the shareholders' tax liability from S operations.

A shareholder's stock basis may be decreased, but not below zero, by the sum of

- distributions by an S corporation, including the fair market value of distributions of property other than cash, not includable in the distributee's gross income under *IRC* §1368(c)(2) (*i.e.*, earnings and profits distributions), *IRC* §1367(a)(2)(A);

- a pro rata share of items of loss and deduction of the corporation that were separately computed and nonseparately computed under *IRC* §§1366(a)(1)(A)–(a)(1)(B), §§1367(a)(2)(B)–(a)(2)(C); a decrease for a charitable contribution shall be the pro rata adjusted basis of the contribution (this shall not apply to contributions made in taxable years beginning after December 31, 2013). *IRC* §1367(a)(2);

- the pro rata share of an expense of the corporation that is neither deductible nor chargeable to capital income, *IRC* §1367(a)(2)(D); and

- the amount of the shareholder's deduction for depletion under *IRC* §611 with respect to oil and gas property held by the S corporation to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated under *IRC* §613A(c)(11)(B) to the shareholder, *IRC* §1367(a)(2)(E).

See also *Reg.* §§1.1367-1(c)(1)–(c)(3).

If the items of loss and deduction reduce the basis of the stock to zero, the shareholder can continue to deduct these items and reduce the basis of any debts owed to the shareholder by the corporation. If the losses and deductions allocated to a shareholder have reduced to zero the basis of both stock and debt, the shareholder cannot deduct any further losses. Any disallowed loss or deduction is carried over indefinitely, and may be used when the shareholder's basis is increased through additional capital contributions, loans, or net operating income. *IRC* §1366(d)(3).

Attorneys must recognize that the stock-basis adjustments are applied on a block-by-block approach and not an aggregate or unitary basis approach mandated by the partnership rules. Nevertheless, the regulations permit a shareholder to apply losses, deductions, and distributions in excess of the basis of a particular block of stock against the remaining basis of the shareholder's other blocks of subchapter S stock. *Reg.* §1.1367-1(c)(3). This effectively results in an aggregate or unity stock-basis rule.

3. [§11.83] Corporate Borrowing

Shareholders in an S corporation are not permitted to increase their basis in stock by the amount of corporate-level indebtedness. See *IRC* §1367(a)(1). Because those amounts may not be added to stock basis, shareholders, in deducting losses or reporting gain or loss on the sale of stock, are limited to their adjusted stock basis (equity investment, net of aggregate income, or loss passed through from prior operations). This general rule is not applicable to partners in a partnership, when entity-level borrowing often results in an increase in a partner's basis in the partnership interest by a proportionate amount of the debt. See *IRC* §752.

However, a shareholder is permitted to claim losses from the pass-through of corporate-level deductions once his or her stock basis has been reduced to zero to the extent of debt basis. *IRC* §1367(b)(2)(A); *Reg.*

§1.1367-2. Debt basis initially reflects the amount of funds advanced by the S shareholder to the corporation, less principal repayments.

For an S shareholder to increase the basis in stock for debt, the money must be borrowed directly from the lender and then contributed directly by the shareholder to the capital of the corporation. Moreover, shareholder guarantees do not increase basis until payment on the guaranty is made. But see *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (guaranty by shareholder of corporate debt may be viewed as direct loan to shareholder with imputed loan to corporation); *Gilday v. Commissioner*, ¶82,242 T.C.M. (P-H), 43 T.C.M. (CCH) 1295 (1982) (substitution of personal note for corporate obligation established basis for pass-through of net operating loss despite lack of subrogation under state law). Compare *Hitchins v. Commissioner*, 103 T.C. 711 (1994). See Winston, *Shareholder Guarantees of S Corporation Debt: Matching the Tax Consequences With Economic Reality*, 81 Va.L.Rev. 223 (1995). The regulations provide special rules when applying the debt rules for multiple debt instruments issued to a shareholder and open account debt. See *Reg.* §1.1367-2(a), (b)(3). It is also important to note that basis in stock (or debt) for purposes of the S provisions is a separate computation from determining "at-risk" basis for losses under *IRC* §465.

Although full review of this area cannot be undertaken in this chapter, it should be noted that it is possible that the application of these two basis limitation rules may produce different results for the same economic event. See August, *The Basis Triathlon: Basis Traps for Shareholders of S Corporations*, 48th N.Y.U. Tax Inst. (1989).

C. [§11.84] Basis In Indebtedness

The basis of a shareholder's loan to an S corporation will generally be the face amount of the loan. If the pass-through of losses and deductions decreases the stock basis to zero, any excess amount may be deducted by the shareholder to the extent of debt basis, reducing the basis of the debt obligation by a corresponding amount. *IRC* §1367(b)(2)(A); *Reg.* §1.1367-2(b)(1). Basis in debt, however, is not reduced for shareholder distributions, and any excess of the value of property distributed over stock basis constitutes taxable gain. *IRC* §1368(b).

The ability to reduce basis of indebtedness for the pass-through of losses and deductions enables a shareholder to currently deduct his or her share of the losses on the tax return. The reduction in indebtedness provision does not apply, however, to any debt of a corporation owed to a third party, even if guaranteed by the shareholder. *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988), *aff'd* 875 F.2d 420. Compare *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985).

If a shareholder has decreased basis in debt and is subsequently allocated income from the corporation, the increase in basis must be applied first to restore previously reduced debt for the pass-through of S losses after 1982. *IRC* §1367(b)(2)(B). This rule presumably restores basis only to the outstanding balance of principal in the obligation. Any amounts of income passed through in excess of the amount required to be restored to debt basis will increase stock basis under *IRC* §1367(a)(1). See also the examples provided in *Reg.* §1.1367-2(e). See §11.82.

D. [§11.85] Loss Limitation Rule

Shareholders may currently deduct their proportionate (daily) share of a corporation's losses, first to the extent of their basis in stock and then to the extent of indebtedness owed to them by the corporation. Losses in excess of basis in stock and debt cannot be deducted in the current year but may be carried forward for subsequent years of the S corporation and deducted as basis is restored. *IRC* §1366(d)(2). See *Reg.* §1.469-2T(d)(6). (The 2004 American Jobs Creation Act added the provision that if stock is transferred between spouses and a loss occurs that exceeds the basis in stock and indebtedness of the transferor, then the transferee is entitled to report the deduction in the succeeding year when basis is restored. *IRC* §1366(d)(2)(B).) The character of each item of loss or deduction carried forward to a subsequent year presumably will be preserved by treating each separate item of loss or deduction as separately carried forward on a proportionate basis. This rule essentially mimics the same provision contained in the partnership area. See *Reg.* §1.704-1(d)(2).

E. [§11.86] Post-Termination Transition Period

If, in the last taxable year of an S corporation (when the S election is terminated), a loss is passed through to shareholders who are unable to deduct it because of insufficient stock (or debt) basis, those shareholders are permitted a period of time after the election terminates to increase basis in stock by making additional capital contributions (but not debt) or, through the purchase of additional shares of stock from other shareholders, to deduct the suspended loss even though during that period the corporation is taxed as a regular or C corporation. *IRC* §1366(d)(3)(A). This increase must be in stock and not debt. *IRC* §1366(d)(3)(B). This "post-termination transition period" normally is the later of the day that is one year after the last day of the last S year, or the due date for filing the return for the last year as an S corporation. *IRC* §1377(b)(1)(A). If a loss is absorbed in a post-termination transition period, that loss reduces the basis in stock. *IRC* §1366(d)(3)(C).

If the corporation and the IRS disagree over whether the corporation had terminated its election for a prior year, the post-termination transition period is extended for 120 days after the date of the determination that the corporation failed to maintain eligibility as an S corporation. See *IRC* §1377(b)(2) for the definition of "determination."

Losses of an S corporation that are suspended under the at-risk rules of *IRC* §465 are carried forward to the S corporation's post-termination period. *IRC* §1366(d)(3)(D).

F. [§11.87] Family Group

The IRS may adjust tax items of an S corporation among family members — even family members who are not shareholders — to properly reflect reasonable compensation to any family member for services rendered or capital furnished to the corporation. *IRC* §1366(e). This provision gives the IRS broad power to deal with situations in which a family is using an S corporation as a device to shift income among its members.

Unlike the family partnership rules of *IRC* §704(e), the adjustments in this area may involve a family member who is not a shareholder in the S corporation. Any individual providing services or capital to the corporation, therefore, must be compensated properly. Likewise, it will not be possible to make interest-free loans to the S corporation, because *IRC* §1366(e) requires "reasonable compensation" for the furnishing of capital to the corporation. See also *IRC* §§467, 1272, 7872.

G. [§11.88] Worthless Stock And Bad Debts

IRC §165(g) gives a shareholder a tax loss for stock that becomes worthless, equal to the shareholder's basis in the stock. Unless this stock constitutes *IRC* §1244 stock, the loss will generally constitute a capital loss for tax purposes. For worthless debt obligations of a corporation held by a shareholder, *IRC* §166 allows a deduction for the amount of the unsatisfied obligation.

Generally, shareholder loans to a corporation constitute short-term capital losses under the nonbusiness bad debt provision in *IRC* §166(d). When stock or a debt becomes worthless during a taxable year, *IRC* §1367(b)(3) provides that the pass-through of income and loss and resulting adjustments to basis for those items under *IRC* §§1366 and 1367 will apply before determining the amount of any worthless stock or bad debt deduction. Thus, if an S corporation has suffered an operating loss in its final year and its stock has become worthless, a shareholder will be able to report a share of the operating loss (and reduce basis in stock) before determining the amount of the worthless stock loss under *IRC* §165(g). This may have the benefit of avoiding capital loss treatment, which generally can be deducted only against capital gains. See *IRC* §1211(b).

H. [§11.89] Allocation During Termination Of Shareholder's Interest

When a shareholder completely terminates interest in the corporation during the taxable year, all "affected shareholders" may agree to hypothetically close the books and records of the corporation as of the date before the shareholder's termination in allocating tax items to the terminating shareholder during the shareholder's period of ownership. *IRC* §1377(a)(2). The closing of the books applies only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom the shareholder has transferred shares during the year. *IRC* §1377(a)(2)(B). Otherwise, the general rule of a daily pro rata allocation will apply over the entire taxable year of the corporation and to the terminating shareholder for the number of days of stock ownership in the corporation during that period. *IRC* §1377(a)(1).

I. [§11.90] Other Considerations

No special allocations of tax items may be made by shareholders in an S corporation, in contrast to the flexibility given partners in partnerships under *IRC* §704(b)(2). Allocations of tax items are made to all shareholders in proportion to their percentage of stock ownership for the entire taxable year, regardless of whether their stock is voting or nonvoting. No allocation of tax items is made with respect to holders of straight debt instruments, even if they are recharacterized as equity for other purposes.

VII. DISTRIBUTIONS

A. [§11.91] In General

The taxation of distributions to shareholders is generally subject to two different sets of rules, the application of which depends on whether the distributing S corporation has accumulated earnings and profits from prior subchapter C or subchapter S years. A third, more limited provision applies to distributions of cash during a post-termination transition period. As an initial reference point, the term "earnings and profits" essentially reflects the net income of a corporation. For regular corporations, a separate calculation is required to be made of current earnings and profits for the taxable year, as well as an aggregate or accumulated earnings and profits account from prior years.

B. [§11.92] Distributions Without Earnings And Profits

Under *IRC* §1368(b), the distribution rules for S corporations with no earnings and profits (*i.e.*, most new S corporations formed after SSRA) are simple and represent a major reform from prior law. The amount of the distribution is treated as a tax-free return of capital to the extent of a shareholder's basis in stock (and *not* corporate indebtedness). Any excess over stock basis, which under the regulations is entitled to be treated as an aggregate account for this purpose, constitutes gain from the sale or exchange of stock. See *Reg.* §1.1368-1(c).

For example, an S corporation with a single shareholder having taxable income of $200 for a tax year may later distribute $200 in cash or other property without additional tax at the shareholder level, because the shareholder's basis is increased by an equal amount before being adjusted for the distributions. But see the discussion on distributions of appreciated property in §§11.101–11.102.

C. Distributions With Earnings And Profits

1. [§11.93] In General

An S corporation after 1982 will not generate new earnings and profits from current operations. It is possible, however, for it to have earnings and profits

- from years in which the corporation was a regular or C corporation;
- from years in which the corporation was an S corporation before SSRA; or
- as a result of acquiring another corporation in a reorganization described under *IRC* §381.

2. [§11.94] Accumulated Adjustments Account

S corporations having earnings and profits are required to establish a corporate-level account known as the "accumulated adjustments account" (AAA). This account serves as the first distributional tier for S corporations with earnings and profits. The AAA may be distributed in front of an S corporation's earnings and profits and is treated as either a return of capital to the extent of a shareholder's stock basis, or gain from stock. Because of a special rule applicable to distributions during a subchapter S termination year to the extent of AAA, even a new S corporation or an S corporation without earnings and profits is required to compute its AAA. It should be noted that AAA is a corporate-level account and is not allocated to the shareholders as are other items of income, deduction, loss, and credit. Shareholders who are taxed on undistributed AAA may not be shareholders at the time the AAA is distributed. Therefore, the economic impact of AAA on the books of the corporation must be reviewed to assess the mechanics and tax impact of documents and activities such as buy-sell agreements, redemptions, and reorganizations involving an S corporation.

Shareholders receiving distributions in excess of an S corporation's AAA are required to include those excess amounts in gross income to the extent of earnings and profits. *IRC* §1368(c)(3). As noted in §11.58, a special AAA bypass election may be made to mitigate a passive investment income problem.

An AAA includes the S corporation's post-1982 accumulated gross income less deductible expenses and prior distributions allocable to the account. *IRC* §1368(e); *Reg.* §1.1368-2(a)(2). The AAA is not increased for tax-exempt income or decreased for nondeductible expenditures not properly chargeable to capital, such as unreasonable compensation or illegal payments. It must be decreased on a proportionate basis for redemptions of stock treated as an exchange under *IRC* §302(a) or §303(a). See *IRC* §1368(d), (e)(1)(B). For example, if the AAA of an S corporation is $160 and 25% of its stock is redeemed from a shareholder terminating interest in the corporation, the AAA after the redemption will be reduced to $120.

A shareholder may not be entitled to receive a tax-free distribution of AAA when an S corporation has gross income in the year in which the distribution is made (increase to AAA) but has an overall loss for all post-1982 taxable years or negative AAA. Thus, AAA distributions can be made only to the extent of any positive aggregate balance in the account for all post-1982 tax years through the year in which the distribution is made. Under *IRC* §1368(c)(1), once the S corporation's AAA has been adjusted through the last day of the current S year, if the value of distributions made during the year does not exceed the AAA, the distributions are treated in the same manner as if the corporation had no earnings and profits. The distributions constitute return of capital to be recovered tax free to the extent of basis, with any excess to be treated as gain from the sale or exchange of stock.

3. [§11.95] Earnings And Profits

Distributions by an S corporation in excess of AAA, computed as of the end of the year of the distribution, constitute dividend income to the shareholder to the extent of the corporation's earnings and profits from operations from prior subchapter S or C years, or if the account is acquired in a corporate acquisition. *IRC* §1368(c)(2). Any further distributions will be treated as a return of capital to the extent of stock basis, and any excess as gain from the sale or exchange of stock. *IRC* §1368(c)(3). See also *Reg.* §1.1368-2(b).

4. [§11.96] Previously Taxed Income

Before SSRA, a shareholder was taxed on his or her proportionate share of the corporation's undistributed taxable income (UTI) as of the last day of the taxable year. This pass-through of income (without distribution) was referred to as a shareholder's previously taxed income of an S corporation, or PTI. In contrast to corporate-level AAA, the PTI account was personal to each shareholder and distributions of money (only) would qualify as carrying out PTI under former *IRC* §1375(f).

Since SSRA, it is still possible for shareholders of S corporations existing before SSRA to continue to receive cash distributions of existing PTI (or UTI) in the future. No specific manner for distributing PTI, however, has been given in SSRA. Before the issuance of regulations, which were not forthcoming for over 10 years, most practitioners believed that qualifying distributions of cash could be sourced as coming from PTI by shareholders to the extent those amounts would otherwise be treated as distributions from earnings and profits under *IRC* §1368(c)(2). Thus, to the extent of stock basis, distributions of PTI would not be taxable. Distributions of PTI would result in gain if the amount of money distributed exceeded the shareholder's stock basis. The excess was treated as gain from the sale or exchange of stock.

A distribution in excess of AAA is not included in the income of the shareholder to the extent the distribution is a cash distribution and does not exceed the distributee/shareholder's net share of the corporation's PTI immediately before the distribution. *Reg.* §1.1368-1(d)(2). The portion of distribution out of PTI decreases the shareholder's basis in stock and the excess is generally capital gain. A PTI bypass election under *Reg.* §1.1368-1(f)(2)(iii), coupled with an *IRC* §1368(e)(3) election, allows distributions to be made first out of earnings and profits. If a PTI bypass election is not made (but the corporation with the consent of all its affected shareholders elects to bypass AAA, see §11.99), distribution is treated as made first out of PTI and then out of earnings and profits. It should be noted with caution that the PTI provisions continue to have relevance only to those shareholders who held a PTI account in the S corporation for taxable S years beginning before 1983. No new PTI could be generated for taxable years beginning after that date.

5. [§11.97] Distributional Tiers

Distributions (money or value of property) by an S corporation having accumulated earnings and profits are taxed as follows:

- Tier One: Distributions to the extent of the corporation's AAA constitute a return of stock basis and, to the extent they exceed a shareholder's basis in stock, constitute gain from the sale or exchange of stock. *IRC* §1368(c)(1).

- Tier Two: If the distribution exceeds the balance in the AAA, the excess is treated as a dividend to the extent the amount is not in excess of the corporation's earnings and profits. *IRC* §1368(c)(2).

- Tier Three: Any portion of the distribution remaining after application of tiers one and two is treated in the same manner as a distribution by a corporation without earnings and profits. *IRC* §1368(c)(3).

6. [§11.98] Ordering AAA Distributions

Distributions during a taxable year from AAA are allocated to the shareholders in proportion to the value of all distributions made by the corporation during the taxable year. *IRC* §1368(c); *Reg.* §1.1368-2(a). For example, if AAA at the end of the year before distributions is $200 and the S corporation distributed cash and other property with a value of $400 during the taxable year, half of each distribution will be treated as originating from AAA.

7. [§11.99] Election To Bypass AAA

An S corporation may incur a special tax on its excess passive investment income for a year in which passive investment income exceeds 25% of gross receipts and the corporation has accumulated earnings and profits as of the close of the same taxable year. See §§11.108–11.111. The presence of both items for three consecutive years will also result in the termination of the subchapter S election. To avoid this tax (or a termination), the corporation, with the consent of all its affected shareholders, may elect to bypass the AAA account and treat all distributions as first coming out of earnings and profits during the taxable year (tier two) with the balance being treated as being made out of tier three. *IRC* §1368(e)(3). If sufficient distributions of earnings and profits are made during the taxable year so that at the close of the taxable year no undistributed earnings and profits remain, the tax on passive investment income will be avoided. The earnings and profits account presumably will be reduced on a last-in first-out (LIFO) basis, which is the general rule for regular corporations making distributions.

For example, if an S corporation has earnings and profits from pre-SSRA subchapter S years layered ahead of earnings and profits from regular corporation years, the corporation and its shareholders will have to elect to distribute both untainted (S) and tainted (regular or C) earnings and profits.

8. [§11.100] Mid-Year Distributions

The actual tax impact of mid-year distributions to shareholders cannot be determined until the end of the S corporation's taxable year after the pass-through of tax items and corresponding basis adjustments. This is because the basis adjustments for operations described in §§11.81–11.84 are applied before determining the tax impact of distributions or other events occurring during the same year. *IRC* §1368(d).

Income on a distribution from an S corporation, however, is taxable to the shareholder for the taxable year in which it is received. If a shareholder's tax year ends before the tax year of the S corporation making the distribution, the shareholder may have to file an amended return.

D. Distributions Of Appreciated Property

1. [§11.101] In General

An S corporation distributing appreciated property to its shareholders (except under a complete liquidation or certain reorganizations) is required to recognize gain on the distribution as if the property were sold for fair market value. *IRC* §§311, 1371(a). The recognized gain from a distribution of appreciated property is then allocated to the shareholders in proportion to stock ownership.

If the distribution consists of appreciated depreciable or cost recovery property and is made to a 50% or more shareholder, as defined in *IRC* §1239, the resulting gain from the corporate distribution is ordinary income even to the extent it is in excess of recapture amounts from prior years' depreciation.

Because distributions of appreciated property may trigger income recognition (long-term capital gain), it is possible that the distribution itself will be subject to tax at the corporate level under *IRC* §1374. See §§11.106–11.107. Furthermore, distributions of certain types of appreciated property (stocks or securities in another corporation) may result in a passive investment income tax under *IRC* §1375. See §§11.108–11.111.

The distribution of stock by an S corporation in a reorganization, when the receipt of that stock is tax free to the shareholder under *IRC* §§354–356, is excluded from gain recognition.

2. [§11.102] Comparison With Regular Corporations And Partnerships

Under *IRC* §311, gain generally is recognized to the distributing corporation on any ordinary liquidating or nonliquidating distribution, regardless of whether it qualifies as a dividend, as if the asset were sold by the distributing corporation for fair market value. But see *IRC* §§332, 337. The realized gain is then allocated and passed through as a tax item to all shareholders in proportion to stock ownership. This applies whether or not there is a redemption of stock. For partnerships, distributions by a partnership to a partner generally do not result in gain or loss recognition at either the partnership or partner level except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. *IRC* §731(a).

E. [§11.103] Distributions Of Money During Post-Termination Transition Period

A "post-termination transition period" means

- the period beginning on the day after the last day of a corporation's last taxable year as an S corporation and ending on the later of one year after that last day or the due date for filing the return for that last year as an S corporation, including extensions;

- a 120-day period beginning on the date of a determination (a final court decision or entering into a closing agreement) that the corporation's election had terminated for a prior taxable year; or

- a 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 an item of income, loss, or deduction of the S corporation during the S period.

IRC §1377(b)(1). Special rules apply for audit-related post-termination transition periods. See *IRC* §1377(b)(3).

A distribution of money by a corporation to its shareholders during a post-termination transition period can be received tax free by the shareholders in reduction of stock basis to the extent the amount of the distribution does not exceed the corporation's accumulated adjustments account (AAA). *IRC* §1371(e). Distributions of property do not qualify, and distributions of money that are immediately returned to the corporation in the form of a note for working capital may be subject to attack by the IRS, because the transaction may be treated as a distribution of the note itself, which is not money for this purpose. See *McKelvy v. United States*, 478 F.2d 1217 (Ct.Cl. 1973); *Roesel v. Commissioner*, 56 T.C. 14 (1971).

Because distributions from AAA do not constitute dividends for other purposes, an S corporation and all shareholders to whom distributions are made during a post-termination transition period may elect to treat the distribution as being made out of earnings and profits and not AAA, to receive a dividends-paid deduction to avoid a personal holding company tax or accumulated earnings tax. See *IRC* §§562(a), 1371(e)(2).

VIII. CORPORATE-LEVEL TAXES

A. [§11.104] In General

An S corporation that does not have a prior history as a regular or C corporation generally will not be subject to corporate-level taxes, including the alternative minimum tax under *IRC* §55. The exceptions are for S corporations that have converted from C corporation status. *IRC* §§1374, 1375. See August, *Converting from a C to an S Corporation*, 47th N.Y.U. Tax Inst. (1988); August, *Conversions of C to S Corporations: Assessing the Impact of the New Built-In Gains Tax on S Corporations*, 62 Fla. Bar J. 45 (Jan. 1988).

B. Built-In Gains Tax

1. [§11.105] Former Law

Congress amended *IRC* §1374 in 1986. Former *IRC* §1374, however, continues to apply to all S corporations that elected S status on or before January 1, 1987. Under former *IRC* §1374, if an S corporation recognizes net capital gain in excess of $25,000, the net capital gain amount exceeds 50% of its taxable income for the year, and the taxable income for the S corporation for the same period exceeds $25,000, the corporation is subject to a special capital gains tax. The amount of tax is equal to the lesser of the special alternative tax rate under *IRC* §1201 to the extent the gain exceeds $25,000, or the amount of tax the S corporation would pay if it were taxed as a regular corporation under *IRC* §11. The income subject to tax under former *IRC* §1374 is also subject to the 5.5% Florida corporate income tax.

The provisions of former *IRC* §1374 do not apply in the following circumstances:

- If the corporation has been an S corporation for the three immediately preceding taxable years, if it has been in existence for less than four taxable years, or if it has been an S corporation since inception. *IRC* §§1374(c)(1)–(c)(2). Former *IRC* §1374 will apply, even though a corporation meets the exception, if and to the extent the long-term capital gain is attributable to property acquired by the S corporation, within the preceding three-year period before the first day of the taxable year in which the sale occurs, from a regular corporation in which the basis (of the property) was determined in whole or in part by reference to the basis of the property in the corporation/transferor. Former *IRC* §1374(c)(3).

- Certain gains and losses of options and commodity dealers engaged in "mark to market" contracts under *IRC* §1256 for taxable years ending after July 18, 1984. Former *IRC* §1374(c)(4).

2. Current Law

a. [§11.106] In General

The rules governing the taxation of a corporation's distributions to its shareholders, particularly distributions in complete liquidations, were substantially revised by the Tax Reform Act of 1986. This Act repealed the so-called "General Utilities" doctrine that permitted favorable corporate-level tax treatment for certain sales of assets or stock by an S corporation. Now, with limited exceptions, gain or loss is recognized on all liquidating distributions by an S corporation (or C corporation). When an S corporation makes liquidating distributions and was a C corporation within its past 10 taxable years (temporarily reduced to 5 years for 2012 and 2013), double tax will result as if the corporation liquidated on the last day that it was a C corporation. This result is due to the enactment of *IRC* §1374, the built-in gains tax, which was enacted as a backstop to the General Utilities repeal. See *IRC* §336(d). (Under the American Recovery and Reinvestment Act of 2009, Pub.L.No. 111-5, 123 Stat. 115, the 10-year holding period is temporarily reduced from 10 years to 7 years for sales occurring in 2009 and 2010, and under the Small Business Jobs Act of 2010, Pub.L.No. 111-240, 124 Stat. 2556, the period is further reduced to five years for sales occurring in 2011.). This five-year period was extended for the 2012 and 2013 tax years by the American Taxpayer Relief Act (ATRA) of 2012, Pub.L.No. 112-240, 126 Stat. 2313.

Under *IRC* §1374, a C corporation filing an S election is subject to a corporate-level tax, at the maximum rate contained under *IRC* §11, on its net recognized built-in gains for any taxable year beginning in the recognition period. This corporate-level tax is imposed for a period of 10 taxable years (temporarily reduced to 5 years for 2012 and 2013) commencing with the effective date of the C to S conversion (the "recognition period"). Certain corporations that filed S elections before 1987 will avoid the built-in gains tax but could still have been subject to former *IRC* §1374 as discussed in the preceding paragraph. Other types of "qualified corporations" filing S elections during 1987 and 1988 were partially exempt from the application of current *IRC* §1374. Compare former *IRC* §1374, which applied to gains recognized from the sale of a capital asset purchased after the effective date of the S election and sold within the applicable three-year period. Moreover, post-S election asset appreciation was also subject to tax under former *IRC* §1374.

Under *IRC* §1374(d)(1), the ceiling for the amount of built-in gain potentially subject to corporate-level tax for the entire recognition period is the amount by which the fair market value of all assets of the S corporation, including accounts receivable, goodwill, going concern value, intangibles, and all other assets, exceeds the aggregate adjusted basis of all those assets as of the effective date of the conversion. *Reg.* §1.1374-3.

The annual base of the tax is net recognized built-in gains. For this purpose, *IRC* §1374(d)(2) defines net recognized built-in gains as the lesser of (1) the taxable income of the corporation considering only recognized built-in gains less recognized built-in losses, or (2) the corporation's taxable income as if it were a C corporation with certain adjustments. *Reg.* §1.1374-2.

Recognized built-in gain (or loss) is any gain (or loss) recognized during the recognition period from the "disposition" of any asset that the corporation owned as of the C to S conversion date. The term "disposition" is defined broadly and includes not only sales and exchanges, but other income (loss) taken into account during the recognition period if the item would have been required to be included in gross income (deducted) under the accrual method of accounting before the commencement of the recognition period. Thus, for example, a disposition would include the post-C to S conversion effective date of the collection of an account receivable by a cash-method taxpayer or a distribution of appreciated (built-in gains) property to a shareholder. See *IRC* §1374(d)(5)(A).

Any net operating loss or capital loss carry-over from a prior C year may be used to reduce the amount of the tax base for each year during the recognition period. *IRC* §1374(b)(2). A similar provision permits the use of business credit carry-forwards from prior C years. Material changes in stock ownership, such as those accomplished through mergers, reorganizations, or restructurings, which result in an ownership or equity structure shift under *IRC* §382, will affect the gross amount of the usable carry-forwards that may be used to offset net recognized built-in gain. *Reg.* §1.1374-5.

When the taxable income limitation applies, the excess of the corporation's net recognition built-in gains is suspended and carries over to the succeeding year. However, this rule does not apply to C to S conversions that were filed before March 31, 1988. *IRC* §1374(d)(2)(B); *Reg.* §1.1374-2.

A "disposition" includes not only income from sales or exchanges but also other income recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income. *IRC* §1374(d)(5)(A). For example, the collection of accounts receivable earned before the S election but paid after the election to a cash-basis corporation would be a recognized built-in gain. Application of *IRC* §1374 results in the same double-tax bite as if the corporation had remained a regular corporation and made an operating distribution of property to its shareholders. Compare this result with a C corporation that has to affirmatively decide to pay a dividend out of earnings and profits to its shareholders before the second level or shareholder level tax is incurred. Moreover, liquidating distributions of subject assets within the 10-year period (temporarily reduced to 5 years for 2012 and 2013) will also be subject to two levels of taxation.

b. [§11.107] Practical Considerations

Because it is assumed under *IRC* §1374(d)(3) that any gain made during the recognition period is built-in gain, it is imperative that converting S corporations make a complete inventory and appraisal of their assets as of the effective date of election. If the corporation cannot establish the fair market value as of the effective date of the election, not only pre-election gain but also post-election gain may be taxed under *IRC* §1374.

As with the other corporate-level taxes applicable to S corporations, *IRC* §1374 does not apply to an S corporation that has always had an election in effect. The presence of a single C year, however, followed by an uninterrupted period of S years, will still result in application of the corporate-level tax provision in *IRC* §1374. This reemphasizes the importance of a newly organized corporation timely filing its election for its first taxable year. See §§11.48–11.52. In another context, it is possible for an always-S corporation to become subject to the built-in gains tax if it acquires the assets of another corporation in a tax-free merger or similar reorganization. For example, if a C corporation merges into an always-S corporation, the pool of assets of the C corporation acquired by the S corporation is subject to *IRC* §1374 for the succeeding 10-year period (temporarily reduced to 5 years for 2012 and 2013).

If a corporate-level tax is imposed, the amount is treated as a loss sustained by the S corporation during the taxable year. The character of the loss is determined by allocating the loss proportionately among the recognized built-in gains giving rise to the tax. *IRC* §1366(f)(2).

C. Excess Passive Investment Income

1. [§11.108] In General

An S corporation is subject to a "sting" tax on its excess passive investment income for each taxable year in which it has undistributed accumulated earnings and profits at the close of the year and more than 25% of its gross receipts are in the form of passive investment income. *IRC* §1375(a); *Reg.* §1.1375-1(a). See §11.59 regarding the definition of passive investment income. The tax imposed on an S corporation's "excess net passive income" is determined by multiplying the "excess net passive income" by the highest corporate tax rate set forth under *IRC* §11.

The purpose for imposing the tax under *IRC* §1375 was to prevent S corporations with subchapter C earnings and profits from converting operating assets into investment assets in conjunction with an S election. Without the special sting tax, shareholders in an S corporation could avoid a double tax on the investment income realized at the corporate level without first incurring a tax on asset appreciation or on its earnings and profits. This would have been a most attractive scenario for older shareholders, because at death there would be a step-up to fair market value for their shares, and the taxation of gain on unrealized appreciation or the earnings and profits account of the corporation would be avoided completely. Moreover, complete repeal of the passive income requirement would permit a holding company, with accumulated earnings, to elect S status and sidestep the personal holding company and accumulated earnings tax provisions.

2. [§11.109] Determination

"Excess net passive income" is determined by multiplying the corporation's "net passive income" (passive income less allocable expenses) for the taxable year by the following quotient: "passive investment income" in excess of 25% of gross receipts divided by the corporation's total passive investment income for the taxable year. *Reg.* §1.1375-1(b)(1)(i). The corporation's excess net passive income, however, cannot exceed its taxable income. See *IRC* §1375(b)(1)(B). However, net operating losses and capital loss carryovers from prior C years (or from S years) cannot be used in making this determination. Similarly, the "dividends received deduction" under *IRC* §243 is ignored. For discussion of the definition of passive investment income and termination for passive investment income, see §§11.59 and 11.62.

When an S corporation has substantial passive income but also has offsetting losses and other deductions from operations, no tax may result because the *IRC* §1375 tax base is the lesser of excess net passive income or taxable income. *IRC* §1375(b)(1)(B). The year, however, will still count as a year for purposes of applying the three-consecutive-year rule for terminations caused by passive investment income. *IRC* §1362(d)(3)(A). See §§11.58–11.61.

If a passive investment income tax applies at the corporate level, the net amount of a corporation's passive investment income (gross income less the tax) will be passed through to the shareholders for individual reporting. *IRC* §1366(f)(3). As indicated in §11.71, Florida presumably will impose a corporate income tax on the income subject to the tax under *IRC* §1375.

3. [§11.110] Coordination With *IRC* §1374

The taxes imposed by *IRC* §§1374–1375 are coordinated to prevent double taxation if income would otherwise be subject to both. *IRC* §1375(b)(4) provides that the amount of passive income shall be determined by "not taking into account any recognized built-in gain or loss" during the 10-year recognition period. See also *Reg.* §1.1375-1(c)(2). Net recognized built-in gain, therefore, will be subject only to the built-in gains tax and not the *IRC* §1375 sting tax.

To avoid the tax on passive investment income and possible termination, an S corporation may engage in a "cleansing" distribution of its entire subchapter C year earnings and profits account during a particular taxable year. *IRC* §1368(e)(3) provides that an S corporation, with the consent of all "affected" shareholders, may elect to avoid the first tier of AAA (*IRC* §1368(c)(1)) in characterizing distributions made with respect to stock. An affected shareholder is defined as any shareholder to whom a distribution is made by the S corporation during the taxable year. Alternatively, the corporation and its shareholders may file a deemed dividend election without having to make distributions, for all (or part) of the subchapter C year earnings and profits. See *Reg.* §1.1368-1(f). See discussion at §11.58.

4. [§11.111] Miscalculation Of Subchapter C Earnings And Profits

If a corporation erroneously concludes that it had no accumulated earnings and profits, the IRS may waive the tax under *IRC* §1375 if the corporation can satisfy the Secretary of the Treasury or the Secretary's designee that the erroneous determination was made in good faith, and within a reasonable time after the determination C earnings and profits were distributed to the shareholders and included in gross income. *IRC* §1375(d); *Reg.* §1.1375-1(d).

D. [§11.112] LIFO Recapture

Under *IRC* §1363(d), an S election by a C corporation that uses the last in-first out method (LIFO) of inventory accounting is required to recapture the excess of the LIFO over first in-first out (FIFO) spread and include that amount in gross income for its final C year. The additional corporate-level tax is payable in four equal annual installments, beginning with the due date for filing the corporation's last C year return and on each of the three succeeding anniversary dates thereafter. *Reg.* §1.1363-2. The regulations extend the LIFO recapture rules to an S corporation that succeeds to LIFO inventory in a tax-free reorganization.

IX. OTHER PROVISIONS

A. Passive Activity Loss Rules

1. [§11.113] In General

Under *IRC* §469, an S corporation shareholder may deduct losses from "passive activities" only to the extent of gains from those activities. A passive activity generally includes any rental activity and any other business activity in which the shareholder does not "materially participate." *IRC* §469(c)(1). Rental activities are treated as passive activities whether the shareholder participates or not, unless the rental activity falls within one of the exceptions in *Temp.Reg.* §1.469-1T(e)(3)(ii). *IRC* §469(j)(8). See §11.114. For taxable years beginning after 1993, an exception from the passive loss rules is provided for certain rental real estate activities if the individual can establish that (1) more than half of the personal services the taxpayer performs in trades or businesses during the year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the individual performs more than 750 hours of services during the taxable year in real property trades or businesses in which he or she materially participates. *IRC* §469(c)(7).

Interest attributable to a passive activity under *IRC* §469 must be distinguished from investment interest under *IRC* §163. For purposes of *IRC* §§163 and 469, interest expense is allocated on the basis of the use of proceeds of the underlying debt. The interest expense allocable to passive activities, therefore, is treated as a passive activity expense and not as an investment interest expense. See *Temp.Reg.* §1.163-8T.

2. [§11.114] Material Participation

A shareholder will be treated as "materially participating" if any one of the following tests in *Temp.Reg.* §1.469-5T(a) is satisfied:

- The shareholder participates in the activity for more than 500 hours during the taxable year. *Temp.Reg.* §1.469-5T(a)(1).

- The shareholder's activity constitutes substantially all of the participation in the activity by *all* individuals for the year. *Temp.Reg.* §1.469-5T(a)(2).

- The shareholder participates for more than 100 hours during the taxable year and no other individual participates more. *Temp.Reg.* §1.469-5T(a)(3).

- If the shareholder participates for more than 100 hours in an activity, that activity will be considered a "significant participation activity." If the shareholder's collective participation in all significant participation activities exceeds 500 hours, the shareholder will be treated as materially participating in each of the significant participation activities. *Temp.Reg.* §1.469-5T(a)(4), (c)(2).

- The shareholder materially participated in the activity for any five of the 10 taxable years immediately preceding the taxable year in question. *Temp.Reg.* §1.469-5T(a)(5). The five years need not be consecutive. For purposes of this test, material participation for any taxable year before January 1, 1987, is determined by using the 500-hour test in *Temp.Reg.* §1.469-5T(a)(1).

- If the activity is a personal service activity, a shareholder who materially participated for any three prior years will be treated as materially participating. The three years need not be consecutive. *Temp.Reg.* §1.469-5T(a)(6).

- The shareholder participates for more than 100 hours during the taxable year and, under all the facts and circumstances, is found to have participated in a regular, continuous, and substantial manner. *Temp.Reg.* §1.469-5T(a)(7).

3. [§11.115] Treatment

Passive losses and credits that cannot be used for the current taxable year are suspended and carried over indefinitely to subsequent years. Suspended passive losses are recognized and may be used to offset any other income on a fully taxable disposition of the shareholder's entire interest in the activity. *IRC* §469(g)(1)(A).

To prevent taxpayers from generating passive income through an activity that would otherwise create active income, merely by not materially participating, *IRC* §469(*l*)(3) allows passive income to be recharacterized as active in certain situations.

A shareholder's basis is reduced for losses passed through from the S corporation under *IRC* §1367 regardless of whether the loss is subject to further limitation under *IRC* §469 or §465.

The preceding discussion highlights only some of the relevant considerations in this area. For specific problems in this area, the reader should review the regulations and treatises on the subject.

B. At Risk Limitations On Losses

1. [§11.116] In General

In addition to the passive loss limitations in *IRC* §465, *IRC* §469 further restricts the deduction of losses to the aggregate amount the shareholder has "at risk" in the activity at the close of the taxable year. If an

S corporation is involved in more than one activity, each activity's profit and loss is figured separately for that year. Certain activities constituting a trade or business are aggregated and treated as one activity if 65% or more of the losses for the year are allocable to shareholders who actively participate in the management of the trade or business. *IRC* §465(c)(3)(B). Exceptions to this general rule are listed in *IRC* §465(c)(2)(A) and include motion picture films, farming, leased *IRC* §1245 property, and certain energy-related activities.

2. [§11.117] Amount At Risk

A shareholder's amount at risk is initially equal to the amount of personal funds and the adjusted basis of unencumbered property the shareholder contributes to the activity. *IRC* §465(b)(1). Amounts borrowed by a shareholder and lent to the corporation increase the shareholder's amount at risk only to the extent that the shareholder is personally liable for repayment of the borrowed amount or has pledged property not used in the activity as security. *IRC* §465(b)(2). An S shareholder is generally not considered at risk for debt owed by the corporation to third parties, even if the shareholder guarantees the debt. *Goatcher v. United States*, 944 F.2d 747 (10th Cir. 1991).

Losses that are suspended because of the at-risk rules are available indefinitely to shareholders in future years after they once again become "at risk." *IRC* §1366(d)(3)(D).

A shareholder's basis is reduced for losses passed through from the S corporation under *IRC* §1367, regardless of whether the loss is subject to further limitation under *IRC* §465.

IRC §465(e) requires a shareholder to recognize ordinary income to the extent that the shareholder has a negative amount at risk.

The preceding discussion highlights only some of the relevant considerations in this area. For specific problems in this area, practitioners should review the regulations and treatises on the subject. See also August & Looney, *S Shareholders Must Still Be Wary of At Risk Rules*, Part I, 3 J. S Corp. Tax'n 99 (Fall 1991), and Part II at 3 J. S Corp. Tax'n 179 (Winter 1992).

C. Fringe Benefits

1. [§11.118] In General

In applying tax provisions relating to employee fringe benefits, the S corporation is treated as a partnership. *IRC* §1372(a)(1). If an S corporation provides fringe benefits to any shareholder owning more than 2% of the stock or more than 2% of the voting stock, the shareholder is treated as a nonemployee or partner and the corporate-level deduction provisions will not be available. The determination of stock ownership is made through application of family attribution rules under *IRC* §318. *IRC* §§1372(a)(2)–(b). For example, medical expenses might be paid by an S corporation to a 5% shareholder. These expenses will not be deductible to the corporation, because the shareholder owns more than 2% of the stock. In this situation, however, *IRC* §162(*l*) permits the shareholder to deduct a percentage of the cost of health insurance provided by the S corporation for the shareholder and his or her family, provided that amount is less than the shareholder's wages from the S corporation. See *IRC* §162(*l*)(2). In contrast to the more-than-2%-shareholder rule, a similar amount paid by the S corporation to a 2%-or-less shareholder may be deductible.

The Code does not define the term "fringe benefits." However, the Senate Report for the 1982 Act stated that fringe benefits include

- exclusion from income of amounts paid by accident and health plans, *IRC* §105(e);
- exclusion for amounts paid by an employer for accident and health insurance plans, *IRC* §106;
- exclusion for cost of up to $50,000 worth of group term life insurance on an employee's life, *IRC* §79; and
- exclusion from income of meals and lodging furnished for the convenience of the employer, *IRC* §119.

2. [§11.119] Qualified Deferred Compensation Plans

For taxable years beginning in 1984, almost the same rules will govern qualified plans of S corporations, partnerships, and regular corporations. Previously, regular corporations enjoyed additional benefits in structuring qualified deferred compensation plans that were not available to S corporations.

D. [§11.120] Compensation Stock

Individuals receiving compensation stock for services are taxed on the fair market value of the stock, subject to the rules under *IRC* §83. If compensation stock is subject to a substantial risk of forfeiture and is not transferable, the year in which the receipt of the stock is includable in income may be deferred until the restrictions are removed. *IRC* §83(c). Issuing compensation stock creates a correlative deduction to the corporation if the amount is required to be included in the gross income of the employee. A special provision in *IRC* §83(b) permits the service provider to elect to include the stock in gross income notwithstanding the presence of a substantial risk of forfeiture.

The final regulations provide that forfeiture provisions that cause a share of subchapter S stock to be substantially nonvested are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights. Therefore, if substantially nonvested stock is treated as outstanding stock because an *IRC* §83(b) election was made with respect to it, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

E. Employment Taxes

1. [§11.121] Withholding And Unemployment Taxes

Payments by an S corporation to its shareholders for services rendered constitute wages for withholding, social security, and unemployment tax purposes. If, however, the amount of these payments is unreasonably low compared to the amount of services performed, the IRS may attempt to impute to the service provider additional wages to which the employment taxes would apply. See *Rev.Rul.* 74-44, 1974-1 C.B. 287. See also *IRC* §1366(e). Generally, no obligation for withholding or employment taxes will be imposed on the corporation for actual dividend distributions subject to tax.

2. [§11.122] Social Security

Many shareholders of S corporations elect not to receive a salary in order to prevent a reduction in their social security benefits. Instead of receiving a salary from the S corporation, the shareholder will elect to receive the S corporation's earnings in the form of a dividend distribution. Even if the shareholder receives the S corporation profits as a dividend distribution, the Social Security Administration may still try to reduce an employee/shareholder's benefits. The argument for reducing social security benefits is generally strongest when actual payments are made by the corporation, in contrast to when the income derived from the corporation is merely passed through for tax reporting purposes while distribution of the earnings is deferred by the corporation. See *Ludeking v. Finch*, 421 F.2d 499 (8th Cir. 1970). If the S corporation is actively engaged in a trade or business and the shareholder/recipient is active in management, the benefits may be reduced for that person's share of the business income, because that person's share of income is no longer characterized as a dividend.

3. [§11.123] Self-Employment And Employment Taxes

Before SSRA, a shareholder's portion of subchapter S income, either actual distributions or taxes reported on undistributed taxable income, was not considered earnings from the conduct of a trade or business, and thus the self-employment tax was not applicable. Under SSRA, however, a shareholder is required to include a proportionate share of the S corporation's income as if it were "realized directly from the source from which realized by the corporation, or incurred in the same manner." *IRC* §1366(b). An argument may be made, therefore, that a shareholder's proportionate share of active trade or business income generated by an S corporation (and not distributed in the form of wages) is subject to self-employment tax under *IRC* §1402.

The wages paid to an S corporation shareholder for services are subject to federal unemployment and social security taxes.

F. [§11.124] Estimated Taxes

S corporations pass income and losses through to the shareholders in a manner similar to a partnership. *IRC* §1366. Partners in a partnership are required by *IRC* §6654 to report income and loss items flowing through from the partnership on a quarterly basis for purposes of the estimated tax. See *Reg.* §1.6654-2(d)(2). See also *Rev.Rul.* 87-121, 1987-2 C.B. 217; *Priv.Ltr.Ruls.* 8542034, 8544011. Accordingly, shareholders of S corporations are required to pay estimated tax on their pro rata shares of corporate-level income on each April 15, June 15, and September 15 of the current year, and January 15 of the following year. The mechanics of computing the estimated tax payments are beyond the scope of this material.

An S corporation is required to make estimated tax payments for tax on built-in gains or passive investment income. See *IRC* §6655(g)(4).

X. SHAREHOLDERS' AGREEMENTS

A. [§11.125] In General

All shareholders' agreements should address matters such as the purchase of stock in the event of death or retirement, management and operations of the corporation, declaration of dividends, voting requirements concerning certain fundamental events, proxies, shareholder employment, and voting trusts. See §4.15 of this manual, and FLORIDA CORPORATE PRACTICE §§6.12–6.24 (Fla. Bar CLE 7th ed. 2013) for a general discussion of shareholders' agreements.

B. [§11.126] Checklist

COMMENT: The following special provisions should be considered in preparing a shareholders' agreement for an S corporation.

- **Prohibition on transfer to an ineligible shareholder by mandatory purchase or right of first refusal option. See §§11.18–11.29.**

- **Liquidated damages clause in the event the election is terminated. Because the shareholders of an S corporation may be adversely affected by the loss of the election, insertion of a liquidated damages clause in a shareholders' agreement may be desirable. If a liquidated damages clause is inserted, factors that should be considered in arriving at the proper amount of damages are the marginal tax brackets of the aggrieved shareholders; the period in which the corporation may not re-elect subchapter S status; the additional corporate-level tax paid during the period of ineligibility to re-elect; the shareholders' basis in stock as of the time of the terminating event; whether there should be an obligation to mitigate damages by appealing the loss of the election with the IRS; and the period in which the**

damages are to be measured.

- **Revocations. See §§11.56–11.57.**
    - **Requiring greater than a majority of shares to effect a revocation.**
    - **Setting procedures concerning filing of a prospective revocation.**
- **Hypothetical closing of books, in the event of a termination of election or shareholder's interest in the corporation. See §11.63.**
- **Distributions.**
    - **Mandatory distributions to allow shareholders to meet federal income tax obligations, because shareholders report corporate-level income without regard to cash flow. See §§11.78–11.79. Timing of distributions to coincide with required estimated tax filing (and payment) dates.**
    - **Restrictions on distributions of appreciated property. See §§11.101–11.102.**
    - **Provisions concerning elections to distribute out of earnings and profits instead of AAA for subchapter S years and post-termination transition periods. See §§11.99–11.103.**