

December 2019

## Closely Held Corporations: An Analysis of Subchapter S

Charles G. Kepler

Follow this and additional works at: <https://scholarship.law.uwyo.edu/wlj>

---

### Recommended Citation

Charles G. Kepler, *Closely Held Corporations: An Analysis of Subchapter S*, 13 Wyo. L.J. 214 (1959)  
Available at: <https://scholarship.law.uwyo.edu/wlj/vol13/iss3/2>

This Article is brought to you for free and open access by Law Archive of Wyoming Scholarship. It has been accepted for inclusion in Wyoming Law Journal by an authorized editor of Law Archive of Wyoming Scholarship.

# CLOSELY HELD CORPORATIONS: AN ANALYSIS OF SUBCHAPTER S\*

CHARLES G. KEPLER\*\*

In 1958, Congress enacted legislation permitting certain closely held corporations to elect, with the consent of shareholders, to have corporate income taxed and corporate losses deducted at the shareholder, rather than the corporate level.<sup>1</sup> During such time as an election is in effect, the double tax on corporate profits is eliminated.

This legislation is contained in a new Subchapter S (Sections 1371-1377, inclusive) which has been added to Chapter 1 of the Internal Revenue Code of 1954. Hence, the legislation is frequently referred to as "Subchapter S." Other, somewhat more exotic references are also in vogue. For example, "Corporations Electing To Be Taxed As Partnerships," "Tax-Option Corporations," and "Pseudo-Corporations" are currently being used in trade journals to describe this legislation. It seems to me that such references may have misleading connotations and I prefer to allude to the new provisions simply as Subchapter S. For example, there is a high degree of similarity between the tax treatment of a partnership and the tax treatment of a corporation which has made an election under Subchapter S, but it is a similarity and not an identity. To equate the results of a Subchapter S election with those of a partnership can be misleading. Before a corporation may make an election under Subchapter S, it must in fact be a domestic corporation. Furthermore, an electing corporation remains a corporation for most tax purposes, and for all other purposes. It hardly seems appropriate therefore to refer to electing corporations as pseudo-corporations.

## I. ELIGIBLE CORPORATIONS

The provisions of Subchapter S are available to "small business corporations" only.<sup>2</sup> For these purposes, a "small business corporation" is a

---

\*This paper was originally prepared for and delivered at the Institute on Federal Tax Problems of the General Practitioner held at Laramie, Wyoming, on March 6 and 7, 1959, under the sponsorship of The College of Law of the University of Wyoming. At that time, the Treasury Department had issued only temporary regulations covering for the most part the mechanical aspects of making an election under Subchapter S. The paper dealt to a large degree with some of the questions left by the statute to determination by regulation. Apparently, the pressure on the Department for more complete regulations was substantial for on March 12, 1959, proposed regulations were issued, well in advance of the Department's normal schedule for issuing new regulations. It has been necessary to revise the paper to take into account the answers furnished by the proposed regulations and to make appropriate footnote references. No effort has been made to include in the paper the pitfalls of a Subchapter S election created by the Treasury Department's interpretations. Any corporation or corporate shareholder contemplating an election would be well advised to study in advance these proposed regulations.

\*\*Mr. Kepler received his LL.B. degree from the University of Wyoming in 1948 and his LL.M. degree from the University of Michigan. He is presently employed as General Attorney, Husky Oil Company in Cody, Wyoming.

1. § 64, Technical Amendments Act of 1958, P.L. 85-866, Sept. 2, 1958.

2. § 1372 (a), I.R.C. Section references herein are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

domestic corporation which is not a member of an affiliated group and which has only one class of stock owned by not more than 10 shareholders, all of whom must be either persons or estates, and none of whom may be non-resident aliens.<sup>3</sup> In addition there are certain restrictions on the source of a corporation's income which we will note later.<sup>4</sup>

A corporation that is a member of an affiliated group of corporations is not an eligible corporation even though the group has never filed a consolidated federal income tax return.<sup>5</sup> However, if a corporation makes an election under Subchapter S at a time when it is not a member of an affiliated group, it may later acquire an 80 per cent or more subsidiary without losing its qualification as a small business corporation.<sup>6</sup>

In order to qualify as a small business corporation, a corporation must have only one class of stock. In applying this test only the outstanding stock need be considered. Treasury stock and authorized but unissued stock of a class other than the class of outstanding stock will not disqualify the corporation. Each share of the issued and outstanding stock must have identical voting, dividend and liquidation rights. However, the "grouping" of stock as to voting rights will not disqualify the corporation provided each such group has the right to elect directors in a number proportionate to the number of shares in each group and provided the groups otherwise have identical rights.<sup>7</sup>

Beneficial ownership and not record ownership is used in applying the stock ownership tests. The person required to include in his individual return dividends from the corporation is considered to be a shareholder. Thus, where the stock is community property, or held in common, joint tenancy, or tenancy by the entirety, each co-owner is considered a shareholder.<sup>8</sup> Stock held under the Uniform Gifts to Minors Act or the Gifts of Securities to Minors Act is considered as being owned by the named minor.<sup>9</sup> Stock owned by a trust, including voting trusts, or by a partnership disqualifies a corporation.<sup>10</sup>

"Net worth" of a corporation is not a factor in the definition of a "small business corporation." This probably is not as significant as it may sound, since the corporation's income under a Subchapter S election will be taxed to the individual shareholders at the individual tax rate. At some point, depending upon the number of shareholders, the dividend policy,

---

3. § 1371 (a).

4. See § 1372 (e) (4) and (5), relating to "foreign income" and personal holding "company income" restrictions.

5. See § 1504 for definition of "affiliated group."

6. Proposed Reg. § 1.1371-1 (c).

7. Proposed Reg. § 1.1371-1 (g).

8. Proposed Reg. § 1.1371-1 (d). However, the Senate Finance Committee Report states that shareholders are those of record for the purpose of determining who must consent to an election. See S.R. No. 1983, p. 89.

9. Technical Information Release published November 26, 1958.

10. Proposed Reg. § 1.1371-1 (d).

and the outside income of the individual shareholders, a Subchapter S election would not be desirable.<sup>11</sup>

## II. ELECTION

The provisions of Subchapter S are not automatic. Before the provisions apply it is necessary for the corporation to file an election and all of the shareholders consent in writing to that election.<sup>12</sup> The corporation's election should be made on a Form 2553 and must be filed with the District Director either during the first calendar month of a taxable year of the corporation or during the month immediately preceding.

The consent of a shareholder must be in the form of a signed statement setting forth the name of the shareholder, the name and address of the corporation, the number of shares of stock owned by the shareholder, the date or dates on which stock was acquired, and a consent to the election of the corporation. The consents of all shareholders may be incorporated in such statement. The consents of all shareholders must be attached to the election of the corporation. The consent of an estate may be signed by the executor or administrator of the estate. The consent of a minor may be signed either by the minor or by his legal guardian or his natural guardian if no legal guardian has been appointed.<sup>13</sup>

Once an election has been made, it will remain in effect for all subsequent years until it is terminated.<sup>14</sup>

## III. TERMINATION OF ELECTION

Once an election has been made, there are five ways in which it may be terminated. Only one of these, formal revocation, requires the consent of all shareholders. The others do not require the consent of the shareholders and may occur even without their knowledge. An unplanned termination can have unfortunate consequences. Before the election is made each shareholder will or should have given serious thought to the effect the election will have on his personal tax situation. In not a few instances a shareholder will have adjusted his other business affairs to prevent pyramding of income in any year. For example, he may have laid plans to use in his own return anticipated capital gains from the corporation to offset personal capital losses. In fact, an intelligent election under Subchapter S should be preceded by a carefully planned tax program for all shareholders as well as for the corporation. An unanticipated termination can wreck havoc with such a plan.

Furthermore, once an election has been terminated for any reason, a

---

11. In general an election will not be desirable where the marginal tax rates of the individual shareholders are in excess of the corporate tax rate if the earnings are to be left in the business. If the earnings are distributed, the marginal tax rate for shareholders can exceed the corporate tax rate to some extent without an aggregate increase in taxes since the double tax is eliminated.

12. § 1372 (a).

13. Proposed Reg. § 1.1372-3 (a).

14. § 1372 (d).

new election may not be made for any taxable year of the corporation prior to its fifth taxable year which begins after the year in which the termination is effective without the consent of the Secretary of the Treasury.<sup>15</sup>

It follows that everything should be done in advance of the initial election that can be done to prevent unplanned for terminations.

#### A. *New Shareholders*

The introduction of a new shareholder may cause a termination. If a new shareholder does not consent in writing to the election and if that consent is not filed within thirty days, commencing on the day on which he becomes a shareholder, the election is automatically terminated.<sup>16</sup> If the new shareholder is an estate, the thirty day period is measured from the date on which the executor or administrator is appointed.<sup>17</sup>

The death of a shareholder or a gift of stock as well as a sale of stock can result in a new shareholder. Since the inadvertence or design of one shareholder can cause problems for all of the shareholders, one should give thought to securing in advance of an election an agreement among the shareholders restricting the disposition of stock. Suggesting such an agreement is far simpler than working out its details.

#### B. *Loss of Qualification*

An automatic termination will occur in any year in which the corporation ceases to be a "small business corporation."<sup>18</sup> Basically, the definition of a "small business corporation" relates to the number and identity of shareholders. Consequently, the suggested agreement among shareholders can do much to prevent this disqualification.

#### C. *Income from Sources Outside United States*

The third automatic termination provision will not cause most corporations any difficulty. It relates to income from sources outside the United States. If, in any year, the corporation receives more than 80% of its gross receipts from sources outside the United States, the election is automatically terminated.<sup>19</sup>

#### D. *Personal Holding Company Income*

The fourth automatic termination provision also relates to the sources

---

15. § 1372 (f). "The fact that more than 50 per cent of the stock in the corporation is owned by persons who did not own any stock in the corporation during the taxable year for which the termination is applicable will tend to establish that consent should be granted. In the absence of such fact, consent will ordinarily be denied unless it can be shown that the event causing the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and was not part of a plan to terminate the election in which plan such shareholders participated." Proposed Reg. § 1.1372-5 (a).

16. § 1372 (e) (1).

17. Proposed Reg. § 1.1372-3 (b).

18. § 1372 (e) (3).

19. § 1372 (e) (4). Sections 861-864, relating the determination of sources of income may offer some assistance in determining the source of gross receipts.

of the corporation's income. If, in any year, the corporation receives more than 20% of its gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities, the election is automatically terminated.<sup>20</sup> This provision will automatically eliminate a number of corporations that might otherwise qualify to make an election under Subchapter S. The statute refers to this class of income as personal holding company income. It should be noted that personal holding company income as defined in Subchapter S is similar to but is not identical with the personal holding company income defined in the Personal Holding Company Tax.

#### E. *Revocation*

The fifth means of terminating an election is by formal revocation. A corporation may revoke its election provided it has the written consent of all shareholders.<sup>21</sup> Such a revocation may not be made in the initial year of the election but it may be made in any subsequent year. A revocation filed on or before the close of the first month of the corporation's taxable year is effective that year. If it is filed later, it is effective the succeeding taxable year.

### IV. EFFECT ON SHAREHOLDERS

What effect will a Subchapter S election have on shareholders? As already noted, the purpose of Subchapter S is to shift the corporate income and losses to the shareholders and to eliminate the double tax. In considering the means by which Subchapter S accomplishes the purpose, two things should be kept in mind: First, although for the most part Subchapter S is applicable only to years in which an election is in effect, there are consequences that will carry-over to post election years.<sup>22</sup> Second, although Subchapter S makes no distinction between newly formed and already existing corporations, the application of the rules to an existing corporation with accumulated earnings and profits can create some tax problems for the future.

#### A. *Corporation Income*

For any year in which an election is in effect, the corporate income is taxed to the shareholders as dividends.<sup>23</sup> To accomplish this, Subchapter S changes the law relating to corporate dividends in three ways: (1) it has created what might be called a constructive or "as if" dividend as a means of taxing to the shareholders the corporation's "undistributed taxable income" for the year; (2) it modifies the rules relating to the taxing of distributions paid to shareholders; and (3) it provides special rules to capital gains of the corporation and to the dividend exclusion and credit and the retirement credit allowed shareholders.

20. § 1372 (e) (5). Gross receipts from sales or exchanges of stock or securities are taken into account only to the extent of the gains therefrom.

21. § 1372 (e) (2).

22. §§ 1372 (b), 1376, and 1377.

23. § 1373 (b).

### 1. *Constructive Dividend*

For any year in which an election is in effect, each person who is a shareholder on the last day of the corporation's taxable year must include in his gross income his share of the corporation's "undistributed taxable income" for that year. The shareholder treats his share as if it had been paid to him as a dividend on the last day of the corporation's year.<sup>24</sup>

"Undistributed taxable income" is a new concept introduced by Subchapter S. It is the taxable income of the corporation computed without reduction for (1) partially tax exempt U.S. interest, (2) dividends received and paid credits, and (3) net operating loss deductions, less cash distributed as dividends during the year.<sup>25</sup>

The elimination of partially tax exempt U.S. interest and dividends received or paid credits in arriving at "undistributed taxable income" will not be significant in most instances. However, the elimination of the net operating loss deduction is the deduction allowed a corporation from its current income for operating losses sustained in other years.<sup>26</sup> In practical effect, what the elimination of the net operating loss deduction means is that in any year in which a Subchapter S election is in effect, neither the shareholders nor the corporation will be able to use previous years' operating losses.<sup>27</sup> In most instances it will be undesirable to make a Subchapter S election until substantially all of the corporation's net operating loss deduction has been used up or lost by time. In instances where there is little or no hope of the corporation generating a profit for several years and the shareholders can make effective use of current losses of the corporation in their individual returns, an election would be advantageous.

You will note that cash dividends paid during the year reduce the "undistributed taxable income." Dividends paid in property do not. In instances where an electing corporation has accumulated earnings and profits, considerable thought should be given before a property dividend is paid.

We might summarize the constructive dividend rule this way:

(1) If no dividends are paid by the corporation during the year, the constructive dividend will be equal to the taxable income of the corporation.<sup>28</sup>

---

24. § 1373 (b). Since the "undistributed taxable income" of an electing corporation is taxed to shareholders as a dividend, the amount taxable to shareholders cannot exceed the corporation's earnings and profits, current and accumulated.

25. § 1373 (c) and (d). Cash dividends reduce "undistributed taxable income" only to the extent they are considered paid out of earnings and profits for the year.

26. § 172.

27. Proposed Reg. § 1.1374-1 (a).

28. As used here and in the following two examples, "taxable income" means the taxable income of the corporation computed without reduction for partially tax exempt U.S. interest, dividends received and paid credits, and net operating loss deduction.

(2) If dividends are paid in cash during the year, the constructive dividend will be the taxable income of the corporation less the amount of the cash dividend.

(3) If dividends are paid in property during the year, the constructive dividend will be the taxable income of the corporation.

Subchapter S taxes the constructive dividend only to persons who are shareholders on the last day of the corporation's taxable year.<sup>29</sup> It has been suggested that this provision would permit a person to be a shareholder for a substantial portion of the year and then, after determining his own tax position and the probable taxable income of the corporation, shift the constructive dividend burden by disposing of part or all of his stock. The disposition might be made by a gift or sale to some member of the family with a lower tax rate or off-setting losses. The proposed regulations state that transactions between members of a family will be closely scrutinized, apparently to determine if they are bona fide.<sup>30</sup>

## 2. Distributions

Dividends paid by an electing corporation are taxable to shareholders under the same rules applicable to corporate distributions generally, with certain limited modifications. Before considering these modifications made by Subchapter S, it may be worthwhile to review briefly general rules relating to corporate distributions.

Corporate distributions to shareholders are taxable as ordinary dividends (unless they fall within one of a few exceptions such as liquidating dividends) to the extent the corporation has either earnings and profits for the year of distribution or earnings and profits accumulated since February 28, 1913.<sup>31</sup> In determining the taxable status of a distribution, you first look to current earnings and profits. If there are sufficient earnings and profits for the current year, the dividend is taxable. If the dividend exceeds current earnings and profits, you look to accumulated earnings and profits. If there are sufficient accumulated earnings and profits, the dividend is taxable. To the extent a dividend exceeds both current and accumulated earnings and profits, it is a return of capital.<sup>32</sup>

The phrase "earnings and profits" is a technical concept that does not have a comprehensive definition in either the Code or the Regulations.<sup>33</sup> It corresponds generally to the corporation's earned surplus, but it is not necessarily identical with the earned surplus concept as it is used by the accountants.<sup>34</sup> The earnings and profits for a year are based upon the

29. § 1373 (b).

30. Proposed Reg. § 1.1373-1 (a) (2).

31. See § 301-316 relating to the taxing of corporate distributions to shareholders.

32. Such a capital distribution reduces the basis of the stock. § 301 (c).

33. § 312 and Regulation § 1.312 contain a number of rules applicable to the determination of earnings and profits of a corporation but they are by no means complete or comprehensive in their treatment.

34. "Earned surplus is the balance of net profits, income, and gains of a corporation



taxable income of the corporation but not necessarily the same. For example, certain income is exempt from taxation and so does not become a part of a corporation's taxable income for the year. Such exempt income is, however, an addition to earnings and profits.<sup>35</sup> Corporations as well as individuals are permitted to take percentage depletion on oil, gas, coal and certain other minerals in arriving at taxable income. Only cost depletion is allowed in determining earnings and profits.<sup>36</sup>

These are examples of how the taxable income and the earnings and profits of a year may differ. It is substantially beyond the scope of this discussion to attempt a comprehensive definition of earnings and profits. For our purposes, it should be sufficient if we understand earnings and profits to be composed of the taxable income of a corporation less taxable dividends and federal income taxes paid. If the exact amount of a corporation's earnings and profits becomes important in a Subchapter S election, care should be used to make certain the figures upon which a decision is made are correct.

The most important modification in Subchapter S to the general treatment of corporate distributions is contained in Section 1375 (d) and is intended to permit the distribution tax free of constructive dividends previously taxed to the shareholders. The first part of this subsection provides:

An electing small business corporation may distribute in accordance with the regulations prescribed by the Secretary or his delegate, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.<sup>37</sup>

The rules concerning the taxability of distributions may be summarized as follows:

(1) Cash dividends are taxable to the extent they do not exceed earnings and profits for the year of distribution. They are taxed to the person receiving the dividend.

(2) Cash dividends in excess of the earnings and profits for the year of distribution are tax free to the extent they do not exceed the shareholder's net share of previously taxed constructive dividends. The corporation may elect, with the written consent of all shareholders, to treat such a dividend as being paid out of accumulated earnings and profits and thus taxable.

---

from the date of incorporation (or from the date when a deficit was absorbed by a charge against the capital surplus created by a reduction of the par or stated value of the capital stock or otherwise) after deducting losses and after deducting distributions to stockholders and transfers to capital-stock accounts when made out of such surplus." Accounting Research Bulletin No. 9, Committee on Terminology of the American Institute of Accountants.

35. Reg. § 1.312-6 (b).

36. Reg. § 1.312-6 (c).

37. § 1375 (d) (1).

(3) Property dividends are taxable to the extent the corporation has earnings and profits, current or accumulated. They are taxed to the person receiving the dividend.

(4) Cash and property dividends to the extent they exceed earnings and profits, current and accumulated, are non-taxable.<sup>38</sup>

It is obvious that a corporation subject to Subchapter S will be quite reluctant to pay a dividend in property.

The second part of Section 1375 (d) defines a "shareholder's net share of undistributed taxable income"<sup>39</sup> In essence, it provides that a "shareholder's net share of undistributed taxable income" is the sum of constructive dividends which have been taxed to the shareholder for "prior years" less such tax benefits as the shareholder has received from the net operating loss of the corporation for "prior years," and less constructive dividends which the shareholder received tax free for "prior years." Under this definition, previously taxed constructive dividends which may be received tax free are a personal matter. They do not follow the stock. If the shareholder transfers part of his stock, his share of previously taxed constructive dividends is not reduced. If he transfers all of his stock, his right to receive tax free previously taxed constructive dividends lapses but again becomes available to him if he subsequently acquires stock while the corporation is subject to the same election.<sup>40</sup>

"Prior years" as used in the statute excludes any taxable year to which Subchapter S does not apply and all taxable years prior to such year. Once an election has terminated for any reason, there is no possibility of receiving previously taxed constructive dividends tax free before all earnings and profits have been exhausted. Furthermore, a re-election does not cure the problem.<sup>41</sup> It is this situation which has been referred to as a "freezing-in" of earnings.

### 3. *Special Rules*

Subchapter S provides two rules on the treatment a shareholder gives a taxable dividend, constructive or actual, in his individual return.

First, the shareholder is permitted to treat as a long-term capital gain so much of his taxable dividends, constructive or actual, as are equal to

38. Proposed Reg. § 1.1375-4 (b) and (c).

39. "For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to — (A) the sum of the amounts included in the gross income of the shareholders under Section 1373 (b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by (B) the sum of — (i) the amounts allowable under § 1374 (b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and (ii) all amounts previously distributed during the taxable year and all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which under paragraph (1) were considered distributions which were not dividends." § 1375 (d) (2).

40. Proposed Reg. § 1.1375-4 (e).

41. Proposed Reg. § 1.1375-4 (d).

his share of the corporation's excess of net long-term capital gains over net short-term capital losses for the year.<sup>42</sup> The amount of long-term capital gains passed-through to shareholders cannot exceed the taxable income of the corporation. The long-term capital gains pass-through is divided among all persons who were shareholders during the year by a mathematical formula based on the amount of the corporation's current earnings and profits which were taxable to each shareholder.<sup>43</sup> Thus, an individual who is a shareholder during part of the year and receives an actual dividend will receive part of the long-term capital gains pass-through even though he is not a shareholder at the end of the corporation's taxable year and not taxed for a constructive dividend.

The second rule relating to the treatment of dividends in the returns of the shareholders is that dividends, actual or constructive, to the extent they are out of current earnings and profits are not eligible for the \$50 dividend exclusion, the 4% dividend received credit, and the retirement credit normally allowed shareholders.<sup>44</sup>

### B. *Corporate Losses*

So far in considering the effect a Subchapter S election will have on shareholders, we have confined our review to the taxing to shareholders of corporate income and distributions. Of equal significance is the effect losses of an electing corporation will have on shareholders.

For any year in which an election is in effect each person who is a shareholder at any time during the taxable year of the corporation is allowed to deduct from his gross income his share of the corporation's net operating loss for that year.<sup>45</sup> The corporation net operating loss for the year is computed without the benefits of the deductions for partially tax exempt U.S. interest and dividends received or paid credits.<sup>46</sup>

A person does not need to be a shareholder on the last day of the corporation's taxable year in order to be allowed the deduction. The shareholder's share of the corporation's net operating loss is computed by a formula which allocates the loss to a daily basis and a shareholder is allowed his pro rata share of this daily net operating loss for the number of days during the year that he is a shareholder.<sup>47</sup>

The shareholder treats his share of the corporate net operating loss as a deduction attributable to a trade or business carried on by him.<sup>48</sup> The deduction is first used by the shareholder against his income for the year.

---

42. § 1375 (a) (1) .

43. § 1375 (a) (2) .

44. § 1375 (b) .

45. § 1374 (a) .

46. § 1374 (b) .

47. § 1374 (b) . It is necessary for a shareholder to be alive at the end of the corporation's taxable year to receive the net operating loss pass-through even though he does not need to be a shareholder at that time. Proposed Reg. § 1.1374-1 (b) (2) .

48. § 1374 (d) (1) .

Any excess may then be carried back two years and forward five years as an individual net operating loss.<sup>49</sup> However, a shareholder may not carry back such a loss to any year commencing before January 1, 1958.<sup>50</sup>

This ability to pass-through to shareholders a corporation's net operating loss will be of particular value to newly organized business ventures. It permits the incorporation of a business to protect the owners from personal liability without the sacrifice of the deduction in the owner's tax return of the losses generated by the business. After the business has commenced generating profit, the election may be revoked if the provisions of Subchapter S no longer afford the best tax result for the shareholders.

There is one limitation on the net operating loss pass-through. A shareholder's share of the pass-through is limited so as not to exceed the sum of his adjusted basis for the stock plus the adjusted basis of any indebtedness the corporation may owe to him.<sup>51</sup> The consequence of this limitation is that corporate losses will have to be anticipated in advance if effective use of the pass-through is to be made. Thought will have to be given before a stockholder loan is paid or reduced. Proposed distributions to be made during or in advance of anticipated loss years will have to be considered in light of the reduction they will make in stock basis. In fact, before a corporation is organized, thought should be given both to the debt-equity structure of the corporation and to the shareholder's basis for assets and capital to be contributed to the corporation. If it appears at any time that the shareholders' basis in stock and corporate debt will be less than an anticipated corporate loss, additional contributions or loan to the corporation may be in order.<sup>52</sup>

### C. *Taxable Years*

In considering the constructive dividends and the net operating loss pass-through provided by Subchapter S we have not considered the possibility of the corporation having a taxable year different from the taxable years of the shareholders. There is no requirement in Subchapter S that the shareholders and the corporation have the same taxable year. An individual shareholder takes into account his share of the corporation's undistributed income or net operating loss in his taxable year in which or with which the taxable year of the corporation ends.<sup>53</sup> Thus, where a shareholder is on a calendar year and the corporation is on a fiscal year ending January 31, the shareholder would have eleven months, in theory at least, in which to adjust his personal income and deductions for the best possible combination with his constructive dividend and net operating

---

49. See § 172 relating to net operating loss deductions.

50. § 1374 (d) (2).

51. § 1374 (c).

52. It is possible that the shareholder may ultimately be penalized to a certain extent for such additional contributions or loan by reason of a subsequent disposal of the stock or debt being taxed to an extent greater than otherwise.

53. § 1372 (b) (2).

loss pass-through. This possibility should not be ignored when the fiscal year of a newly formed corporation is established.<sup>54</sup>

#### D. *Basis of Stock*

During the time a Subchapter S election is in effect, a number of adjustments will occur to the basis of the shareholders' stock.

First, the basis will be increased by the amount of any constructive dividend included in the shareholder's return.<sup>55</sup>

Secondly, the basis will be reduced by the amount of net operating loss pass-through attributable to the stock.<sup>56</sup> To the extent such a pass-through exceeds a shareholder's basis in stock, it reduces the shareholder's basis in any corporate indebtedness owed to him.<sup>57</sup>

In addition to these two special adjustments in basis required by Subchapter S, the provisions relating to corporate distributions in general will require a reduction in basis by the amount of any corporate distribution made to a shareholder which is tax free as a previously taxed constructive dividend.<sup>58</sup>

Although the computation of such adjustments to basis are not complicated, a shareholder will be well advised to keep accurate records reflecting the amount and reason for any adjustments.

#### E. *Allocation of Income*

Subchapter S contains a provision permitting the Secretary to allocate or apportion dividends, actual or constructive, among a shareholder's family to the extent they are also shareholders, if he determines such allocation or apportionment is necessary in order to reflect the value of services rendered to the corporation by such shareholders. The provision is similar to the allocation of income in a family partnership. In fact, Subchapter S takes its definition of "family" from the family partnership provisions.<sup>59</sup> A shareholder's family consists of his spouse, ancestors and lineal descendants. It is reasonable to assume that the Treasury's enforcement of this provision will follow along the same lines of its enforcement of the allocation provision relating to family partnerships.

### V. EFFECT ON CORPORATION

What effect will an election have on the corporation? For any year in which an election is in effect a corporation is not subject to the normal

54. Subchapter S offers some flexibility in deferring or accelerating the taxing of the corporate income to the shareholders. If the corporation is on a fiscal year commencing February 1st and the shareholders are on a calendar year basis, it is possible to defer the taxing of the corporate income to the shareholders by 11 months. Should the shareholders determine that it was better not to defer the income in any particular year, taxability can be accelerated by the payment of a dividend.

55. § 1376 (a) .

56. § 1376 (b) (1) .

57. § 1376 (b) (2) .

58. § 301 (c) .

59. § 1375 (c) .

tax (30%), the surtax (22%), the accumulated earnings tax, and the personal holding company tax imposed by Chapter 1 of the Internal Revenue Code.<sup>60</sup>

Just how significant the elimination of the normal and surtax on the corporation will be depends on the individual tax rates of the shareholders and on the dividend policy of the corporation. If the earnings are to be left in the business, the elimination of the normal and surtax will be beneficial where the shareholders have a marginal tax rate of less than the corporate rate. If earnings are to be distributed, the marginal tax rate of the shareholders can be in excess of the corporate rate since the double tax is eliminated.

The elimination of the accumulated earnings tax and the personal holding company tax will be significant for only a few corporations. The accumulated earnings tax<sup>61</sup> is an additional income tax imposed on corporations that are formed or availed of for the purpose of avoiding income tax on shareholders by accumulating earnings beyond the reasonably anticipated needs of the business. Closely held corporations are more vulnerable to attack under the accumulated earnings tax than corporations with a large number of shareholders. Actually, the Treasury has been notably unsuccessful in its attempted imposition of this tax but it is a problem for some corporations. A Subchapter S election will eliminate the problem.

The Personal Holding Company tax<sup>62</sup> is another additional income tax imposed on corporations. Its purpose is to force the distribution of earnings of a personal holding company to its shareholders where they will be subject to the double tax. The Personal Holding Company tax imposes a heavy, almost confiscatory tax of 75% on the first \$2,000 and 85% on the remainder of undistributed personal holding company income.<sup>63</sup> The tax can be avoided if the net income after taxes is distributed by actual or consent dividends.<sup>64</sup> For growing corporations in need of capital or corporations with a debt structure demanding amortization it is not always possible to distribute net income.

This tax is imposed on personal holding companies only. Unfortunately, a corporation may become a personal holding company almost by accident. Intentional tax avoidance is not one of the elements in imposing the tax. A personal holding company is any corporation in which 80% or more of its gross income for the year is personal holding company income and at any time during the year more than half of its stock is owned, directly or indirectly, by not more than five individuals.<sup>65</sup>

---

60. § 1372 (b).

61. §§ 531-537.

62. §§ 541-547.

63. § 541.

64. §§ 547, 561-565.

65. § 542.

The personal holding company income as the term is used in the Personal Holding Company tax is similar to but not identical with the personal holding company income defined in Subchapter S. It is possible that certain corporations might be a personal holding company but still be able to make an election. Such a situation might arise where personal service income was a major item of income for the corporation.

Actually, there is little reason why the personal holding income restriction should have been included in Subchapter S.<sup>66</sup> An election would result in taxing corporate income to shareholders, the basic purpose of the Personal Holding Company tax. Should this restriction be removed by Congress, Subchapter S will become highly important to the closely held corporation faced with Personal Holding Company tax problems.

The elimination of income tax on corporations does not eliminate the filing of corporate tax returns. An electing corporation is required to file an informational return on Form 1120-S.<sup>67</sup> Neither does an electing corporation cease to be a corporation for purposes of taxation.<sup>68</sup> It is still limited to 5% of its taxable income for the charitable contribution deduction.<sup>69</sup> A corporation is still entitled to deduct its costs for employees' "fringe benefits" such as group life insurance, health and accident insurance, pension and profit sharing plans and the like.<sup>70</sup> Capital losses of a corporation, long or short term, are deductible only to the extent of capital gains.<sup>71</sup>

Another practical effect an election will have on a corporation is a probable increase in the corporate payroll. Some corporations are going to have to add another accountant to keep up with the accounting for an entity that is part fish and part fowl, and to answer the tax questions of the shareholders.

## VI. CONCLUSION

It is impossible to reduce to a formula an evaluation of Subchapter S and to determine when an election should or should not be made. Each situation will have to be determined in light of all the facts, both those that pertain to the corporation and those that pertain to the shareholders. The nature and the prospects of the business are of importance in estimating the effect an election will have in the future.

---

66. For a persuasive argument as to why the personal holding company income restriction should be removed from Subchapter S, see *Few Personal Holding Companies Will Qualify For Subchapter S Election*, by Ben Borsook, 10 *The Journal of Taxation* 19 (January, 1959).

67. § 6037, Reg. § 18.1-1 (e).

68. Proposed Reg. § 1.1372-1 (c).

69. § 170 (b) (2).

70. Where "fringe benefits" are properly handled, the cost is deductible by the corporation but the benefits are not taxed to the individual currently. Equity owners can also be employees of a corporation, and secure the tax advantages of such "fringe benefits." An individual proprietor or partners do not have this same advantage.

71. § 1211 (a).

One might, however, catalogue some of the advantages and disadvantages of an election this way:

For presently unincorporated businesses or for business ventures being newly organized, an incorporation and subsequent election may hold some of the following advantages:

- (1) Insulation of shareholders from personal liability for corporate debts without increasing the over-all tax burden.
- (2) Deduction of employee "fringe benefit" plans without the inclusion in the employee's return of the cost of such plans. Shareholders can be, and often are, employees of a corporation.
- (3) Some improvement in business expense accounting for shareholder-employees.
- (4) A means of spreading equity ownership among employees and family without increasing the over-all tax burden.

Incorporation of a business will have, among others, the following disadvantages:

- (1) Increased costs of record keeping and corporate taxes imposed at state level. Fortunately, we do not have a state income tax but many states do. In those states a major cost to the corporation will be the state income tax computed without deduction for federal income taxes paid.
- (2) The need for and costs of qualifying a corporation to do business in a foreign state.
- (3) Costs to shareholders on the liquidation of the corporation. It is possible to contribute capital and assets to a corporation tax free to the shareholder, but it is difficult to reverse this process.

For corporations already in existence, some of the following advantages may exist:

- (1) Elimination of the double tax.
- (2) The net operating loss pass-through.
- (3) The capital gain pass-through.
- (4) Possible lower tax rates where the shareholders have a marginal rate below the corporate rate.

A possible disadvantage of an election for an already existing corporation is the possible "freeze" in of previously taxed constructive dividends if the election is terminated before the dividends can be distributed.

Although we cannot call Subchapter S a panacea for over-taxed businessmen, it does add another tool to tax planning. Just how valuable this tool will be depends not only on the Treasury Department's regulations and attitude but also on future amendments by Congress. Future amendments, which are bound to come, can liberalize and clarify and they can restrict and make an election less attractive.