Taxation of Subchapter S Corporations and Their Shareholders

Jere D. McGaffey

Benjamin F. Garmer III

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.
TAXATION OF SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS

JERE D. MCGAFFEY* AND BENJAMIN F. GARMER III**

I. THE BASIC RULES OF TAXATION OF THE SHAREHOLDER

A. TAX ON UNDISTRIBUTED INCOME
   1. EFFECT OF NET OPERATING LOSS CARRYOVERS
   2. EFFECT OF PROPERTY DISTRIBUTIONS

B. PREVIOUSLY TAXED INCOME
   1. EFFECT OF NET OPERATING LOSS CARRYOVERS
   2. EFFECT OF PROPERTY DISTRIBUTIONS
   3. EFFECT OF CHANGE IN STATUS
   4. DISTRIBUTIONS OF CASH AND REINVESTMENT

C. DISTRIBUTIONS AFTER THE CLOSE OF THE TAXABLE YEAR

D. EARNINGS AND PROFITS

E. BASIS IN STOCK AND DEBT

F. NET OPERATING LOSSES

II. THE CHARACTER OF THE INCOME

A. CAPITAL GAINS AND LOSSES

B. INVESTMENT CREDIT

III. SPECIAL SITUATIONS

A. CORPORATION AND SHAREHOLDERS WITH DIFFERENT TAXABLE YEARS

B. CHANGE IN STOCKHOLDINGS

C. ALLOCATION OF INCOME

IV. CORPORATE TAX

V. CONCLUSION

In response to the Eisenhower Administration's several proposals, the Congress enacted Subchapter S of the Internal Revenue Code of 1954 as part of the Technical Amendments Act of 1958.¹ The avowed purpose of the Congress was to enable the small business "to select the form of business organization desired without the necessity of

*LL.B. 1961, Harvard Law School; Member of Firm, Foley & Lardner, Milwaukee, Wisconsin.
**J.D. 1966, University of Michigan Law School; LL.M. (Taxation) 1967, New York University Law School; Associate, Foley & Lardner, Milwaukee, Wisconsin.
taking into account the major differences in tax consequences." The provisions of Subchapter S were structured in order that the tax consequences would "operate as simple [sic] as possible."

Subchapter S is generally thought to allow a corporation to be taxed as if it were a partnership. Such terminology undoubtedly arose out of the first proposals for legislation allowing selected corporations to be taxed as partnerships. However, the Commissioner's approach was not to have the corporation taxed as a partnership, and the Treasury Regulations clearly provided that, unless inconsistent with the provisions of Subchapter S, the sections governing Subchapter C corporations are applicable to a small business corporation. Moreover, Subchapter S is not simple; nor is it partnership taxation applied to a corporation. Rather its provisions comprise a hybrid of both Subchapter K and Subchapter C, often reflecting the complex characteristics of both parents.

More than 1,500 neophyte businesses are launched each day, and the number of corporations currently electing Subchapter S exceeds 200,000. Both corporations currently electing Subchapter S and corporations in the process of considering making the election, should engage in an examination of the tax consequences of the election to both the corporation and its shareholders.

I. THE BASIC RULES OF TAXATION OF THE SHAREHOLDERS

A. TAX ON UNDISTRIBUTED INCOME.

A Subchapter S corporation generally is not a taxable entity, but rather the election shifts the incidence of income taxation to the electing shareholders. An appropriate point to begin the analysis of the taxation of shareholders is the situation in which all the income of an electing corporation is distributed during the year. In such an instance, the shareholder of a Subchapter S corporation is taxed, with some modifications, in the same manner as the shareholder would be taxed on distributions from a non-electing corporation. The signifi—

---

5 Treas. Reg. § 1.1372-1(c) (1959) [hereinafter all Treasury Regulation dates given will be date of original promulgation only].
8 Int. Rev. Code of 1954, § 1372(b)(1) [hereinafter all references shall be to the Internal Revenue Code of 1954, as amended, and will be cited as Code], exempts the corporation from the tax imposed by § 11, § 531 (accumulated earnings tax) and § 541 (personal holding company tax), but not the capital gains tax of § 1378 or the tax on preferences of § 56 and § 58(d)(2). § 6037 requires the corporation to file an annual information return, Form 1120S.
9 Corporation C, which did not elect Subchapter S, has $10,000 of income and current earnings and profits and declares a dividend of $10,000. The distribution would be taxable to the shareholders as ordinary income as a dividend.
significant variation in shareholder taxation from Subchapter C occurs where less than all of the corporation's income is distributed during the taxable year. Then, in addition to actual distributions, the shareholder of an electing corporation is taxed on the corporation's undistributed taxable income as if such income had been distributed as a dividend to the shareholder on the last day of the corporation's taxable year.

The amount of undistributed taxable income is the taxable income of the corporation computed in the normal manner, with the exception that any net operating loss carry-forward and the special corporate deductions are disregarded less cash dividends paid by and taxes imposed upon the corporation. This constructive dividend can pass through to the shareholder the tax characteristics of but two categories of income, ordinary income and capital gains. Likewise, ordinary losses can be passed through.

Constructive dividends are deemed to be received by those shareholders who are shareholders on the last day of the taxable year of the electing corporation. Thus, a transfer of stock on the last day of the corporation's taxable year will transfer the taxation of the income of the corporation earned that year to the new shareholder. Income tax advantages can, therefore, be obtained by making gifts of Subchapter S corporation stock at the year end rather than at the beginning of the next year if the corporation has not distributed all of its income during the year. However, if it is intended to shift the ownership of the stock near the end of the year, the transaction should be clearly documented to demonstrate that there has in fact been a transfer.

If the corporation had elected Subchapter S, the $10,000 distribution would likewise be taxable to the shareholders as a dividend. No further tax would be levied on the shareholders since the full amount of the current taxable income has been distributed.

Corporation S has $30,000 of taxable income and has made no distributions during the taxable year. If the stock is held by Shareholder A in the 50% bracket, Shareholder A will pay a tax of $15,000 on the corporation's S undistributed taxable income. However, if the stock is transferred the day before year-end to a shareholder in the 20% bracket, the tax attributable to the undistributed taxable income can be reduced to $6,000. If all the stock is held by a shareholder filing a joint return who has other taxable income equal to $20,000, the constructive distribution will increase his tax liability by approximately $13,000. If, however, the shareholder would transfer 40% of such holdings equally among his four children, the net tax could be reduced to approximately $8,000.

Treas. Reg. § 1.1373-1 (a) (2) (1959) cautions that “transactions between mem-
1. Effect of Net Operating Loss Carryovers

The election of Subchapter S makes a number of changes in the rules governing net operating loss carryovers.

First, a net operating loss sustained during an election year is not allowed as a deduction by the corporation for non-election years.\(^{18}\) The reason for this limitation is clear since the loss has already been reflected in the shareholder's personal return.

Second, net operating losses sustained during a non-election year may not reduce an election year's income.\(^{19}\) This provision results in shareholders receiving no tax benefit from the loss. Such net operating loss carryovers do not directly or indirectly benefit the shareholder either by decreasing the amount of undistributed income taxable to the shareholder, or by reducing the corporation's tax burden, since the corporation is paying no tax.\(^{20}\) In addition, any available carryovers may be wasted, since the five-year carryover period for the expiration of net operating loss deductions is not suspended by election of Subchapter S. If a corporation had a net operating loss incurred prior to electing Subchapter S, then elected Subchapter S but terminated the election after five years, the deduction for the net operating loss carryover would be lost.

The logic of denying the shareholder the benefit of non-election year loss carryovers during an election year is unclear. Neither the corporation nor the shareholders has received the benefit of the loss. The apparent reason for denying the loss carryforward is to prevent shareholders from transferring corporate losses to their personal returns, with the attendant possibility of shifting the loss by transferring stock ownership. However, the Internal Revenue Service has numerous means of denying the successor the loss if the transfer involves tax avoidance purposes and there was a shift in ownership between the year in which the loss occurred and a later year.\(^{21}\)

The prohibition against the carryover of net operating losses from non-election years makes it unwise to elect Subchapter S in situations where there is a net operating loss carryover until after the carryover is entirely absorbed. This course of action is not unduly harsh, however, since there is no corporate tax until the net operating loss carryover is exhausted.

2. Effect of Property Distributions

The undistributed taxable income required to be included in the members of a family will be closely scrutinized," and the Commissioner has been successful in challenging purported transfers. Henry D. Duarte, 44 T.C. 193 (1965).

\(^{18}\) Code, § 1372(b).
\(^{19}\) Treas. Reg. § 1.1374-1 (1959).
\(^{20}\) Even if the corporation is subject to tax by reason of § 1378, this may not be reduced by net operating loss carryovers.
\(^{21}\) Code, § 269.
income of a shareholder is reduced by cash distributions but not by property distributions. A corporation could distribute its total amount of taxable income to shareholders in the form of a property distribution under normal rules, but the undistributed taxable income, as defined under Subchapter S, would not be reduced, and would be constructively taxed to the shareholder as a dividend, to the extent of the corporation's earnings and profits. The amount included in a shareholder's income as a dividend, whether attributable to actual or constructive distributions, is, as in a Subchapter C corporation, limited by the earnings and profits of the corporation. If the corporation has no accumulated earnings and profits, the shareholder reflects as a dividend the actual distribution of property and the constructive distribution of undistributed taxable income, only to the extent of the corporation's current earnings and profits. The current earnings and profits will be allocated to the constructive distribution and property distribution in proportion to the fair market values of each distribution.

If there has been a change in ownership during the year and if the shareholder at the time of a distribution is not a shareholder at the end of the year, an allocation of current earnings and profits to the various distributions is required. The Treasury Regulations provide that earnings and profits must first be allocated to the cash distributions and next allocated ratably to property distributions and constructive distributions of undistributed taxable income. Thus, even if a property distribution occurs before a cash distribution, the cash distribution will always be fully taxable, if there are sufficient earnings and profits, although the total of both the cash distribution and the property distribution may be in excess of current earnings and profits.

There has been general criticism of the discrimination against property distribution. However, it is not completely appropriate to equate

---

22 Code, § 1373(c).
23 Corporation S, with $50,000 of taxable income and current earnings and profits, makes a distribution during the year of property having a basis and fair market value of $20,000 and a cash distribution of $10,000. The undistributed taxable income will be reduced only by the cash distribution. The $20,000 property distribution will not reduce undistributed taxable income, thus resulting in a constructive distribution of $40,000 and actual distribution of $30,000. The entire $70,000 would be taxed as ordinary income provided that the corporation had at least $20,000 of accumulated earnings and profits.
24 Treas. Reg. § 1.1373-1(g), Example (3) (1959).
26 Corporation S, which has no accumulated earnings and profits but current earnings and profits of $20,000, makes distributions of property having a fair market value of $20,000 and cash distributions of $10,000. The cash distribution of $10,000 is fully taxed, leaving $10,000 worth of undistributed earnings and profits. The undistributed taxable income is $10,000. The current earnings and profits is allocated between the $20,000 of property distribution...
cash and property distribution within the context of Subchapter S. Affording distributions of appreciated property and distributions of money the same treatment would result in shareholders being taxed on the full taxable income of the corporation, but would also permit a step up in basis of appreciated property without a concomitant tax on the shareholders.

The concern giving rise to the rules governing property distributions is limited to the extent of appreciation in the property. A more logical method of dealing with this problem is to apply the same rules that determine the effect of or distribution of property on earnings and profits and reduce the amount of undistributed taxable income by the adjusted basis of the property.

**B. Previously Taxed Income**

Failure to distribute all of the taxable income of a Subchapter S corporation results in a relatively unattractive tax picture to the shareholder, since a tax must be paid on income not received. Even if income is not completely distributed, however, the election is desirable if the shareholder’s tax bracket is below that of the corporation, since there will be more money remaining after taxes to be distributed or used in the business, than if the corporation had not elected Subchapter S. Furthermore, the tax impact to the shareholder can be completely eliminated by distributions after the close of the corporation’s taxable year in the amount of the taxes attributable to the constructive dividend.

and the $10,000 of undistributed taxable income. Therefore, $6,667 could be allocated for distribution of the fair market value of the property and $3,333 could be undistributed taxable income. Treas. Reg. § 1.1373-1(g), Example (3) (1959). If shares of stock were transferred after the distributions but before the year-end, the transferor would be taxed on $10,000 for the cash distribution and $6,667 for the property. On the other hand, the buyer would be taxed on $3,333 of the undistributed taxable income and his stock basis increased by a similar amount.

If Corporation S had $100,000 of taxable income and current earnings and profits and distributes property with a fair market value of $100,000 but an adjusted basis of $25,000, the shareholders would still be taxed on $100,000.

In note 28, supra, the basis of the property is stepped up to $100,000 without any capital gains tax to the shareholders.

De Treville v. United States, CCH 1970 STAND. FED. TAX REP. (70-1 U.S. Tax Cas.) § 9162 (D.S.C. Dec. 10, 1969); Code, § 312. See also the treatment of property distributions by personal holding companies. Treas. Reg. § 1.562-1(a) (1958). In note 28, supra, if the distribution of property reduced undistributed income by its adjusted basis of $25,000, the constructive distribution of $75,000 would be fully taxed as well as the distribution of property of $100,000, assuming sufficient accumulated earnings and profits.

Corporation S has approximately $50,000 in taxable income and is owned equally by four shareholders, who file joint returns and who have other taxable income of $12,000 each. If Subchapter S is not elected, the corporation will pay $17,500 in tax. If Subchapter S is elected, the four shareholders’ taxes will be increased by approximately $3,500. However, the total additional tax liability is but $14,000 and, thus, a $4,000 tax savings results. Further advantages are possible in the situations where stock is divided into even more holdings or held by lower bracket taxpayers. Code, § 1375(d); Treas. Reg. § 1.1375-4(b) (1959).

If Corporation S in note 31, supra, a calendar year corporation, on February
Since the shareholder has already incurred a tax on the undistributed taxable income, he may later receive such previously taxed income as cash dividends without tax consequences.\textsuperscript{33} Distributions of previously taxed income occur only if during the corporation's taxable year the corporation makes money distributions in excess of current earnings and profits.\textsuperscript{34} Of course, in the case of a Subchapter S corporation which has always been an electing corporation, it could make distributions even without the provisions, without dividend tax consequences to its shareholders because the corporation would normally have no accumulated earnings and profits. This provision allows corporations which do have accumulated earnings and profits to treat distributions in excess of current earnings and profits as previously taxed income rather than accumulated earnings.\textsuperscript{35}

Since the categorization of a distribution as previously taxed income occurs only after a distribution of all current earnings and profits, a corporation whose current earnings and profits vary significantly from taxable income must use particular care in determining the quantum of distributions. Distributions in excess of current taxable income might still not exceed current earnings and profits and thus be taxable to the shareholder.\textsuperscript{36} This distinction between taxable income and current earnings is seemingly contrary to the basic philosophy of Subchapter S of eliminating the tax considerations in electing the business form. Businesses not operating in the corporate form would not be concerned with such variances.

1. Effect of Net Operating Loss on Previously Taxed Income

A shareholder's portion of previously taxed income is the amount which has been constructively received and included in income of the shareholder, in prior successive electing years less any loss allowed for prior years and less prior distributions of previously taxed income.\textsuperscript{37} The adjustment in the previously taxed income account by the corporation's losses is of questionable merit, since it is discriminatory within the class of electing corporations. Shareholders of corpora-

\textsuperscript{33} \textit{Code}, § 1375(d).

\textsuperscript{34} In 1965, Corporation S has $30,000 of taxable income and distributes only $20,000. In 1966, the corporation again has $30,000 of taxable income but distributes $40,000. In 1965, the shareholders would be taxed on the $20,000 actual distribution and on a $10,000 constructive distribution. In 1966, the shareholders would be taxed on the $30,000 actual distribution and receive the extra $10,000 tax free as a distribution of previously taxed income. \textit{Code}, § 1375(d).

\textsuperscript{35} \textit{Code}, § 1375(d)(1).

\textsuperscript{36} Corporation S has net business income of $20,000 and tax-exempt interest of $2,000. Shareholder A has a previously taxed income account of $10,000. If Corporation S distributes $30,000, $22,000 is subject to tax being equal to the current earnings and profits. Only the remaining $8,000 would be treated as a distribution of previously taxed income. \textit{Code}, § 1375(d)(2).

\textsuperscript{37} \textit{Code}, § 1375(d)(2).
tions which distribute all their earnings are unaffected by the provision since they have received the economic benefit of the distributed earnings and may still utilize the losses. But shareholders of corporations which do not distribute all earnings may find that a single severe loss year has wiped out the previously taxed income account, and thus excised any possibility of the withdrawal of those earnings without tax consequences.

These inequities are increased by the rule that losses which occur in successive electing years prior to a year in which undistributed taxable income is taxed to the shareholders nevertheless reduces the balance of the account. Thus a corporation which during the initial years of operation incurred substantial losses will be excluded from making distributions of previously taxed income, after profitable years, until the constructive distribution exceeds the previous losses. Yet, individuals becoming shareholders after the loss period are not subject to this treatment; this difference in treatment could result in conflicts as to distribution policy between old and new shareholders.

The Internal Revenue Code is explicit in providing that only the losses of a prior year, not those of the current year, reduce the shareholder’s previously taxed income account. Thus, during a loss year, a Subchapter S corporation should give serious consideration to making distributions of previously taxed income in order to avoid reduction in the account by the current year’s losses.

2. Effect of Property Distributions

The Internal Revenue Code’s definition of previously taxed income refers merely to “distributions,” but Treasury Regulations have limited such distributions to distributions of money. This limitation again emphasizes the substantial disadvantage of making any property distribution from a corporation which has elected Subchapter S and which has accumulated earnings and profits, since the property distributions will subject the shareholder to a rather substantial tax liability if the

---

38 Treas. Reg. § 1.1375-4(d) (1959). If Corporation S in 1967 has a net operating loss of $10,000 and in 1968 has undistributed taxable income of $30,000, but makes no distributions, its sole shareholder will have only $20,000 of previously taxed income. Treas. Reg. § 1.1375-4(g), Example (3) (1959).

39 Code, § 1375(d) (2)(B).

40 If, during 1968, Corporation S has a current net operating loss of $10,000 and accumulated earnings and profits of $10,000, and Shareholder A has a previously taxed income account of $10,000, Corporation S could distribute $10,000 to A, during 1968 without tax consequences to him. If, during 1969, Corporation S has income of $10,000 and distributes $20,000 to A, if Corporation S had not distributed the $10,000 in 1968, the net operating loss would have eliminated the previously taxed income account, and the entire $20,000 would be a dividend to A ($10,000 out of accumulated earnings). Code, § 1377(c).

corporation has large accumulated earnings and profits, despite the existence of previously taxed income.\textsuperscript{42}

The Treasury’s concern may have been similar to that involving distributions of current earnings by way of property distributions. If a distribution of appreciated property could be considered a distribution of previously taxed income, the shareholder would receive a step up in basis without incurring a tax. An alternative would be to consider a distribution of property as a distribution of previously taxed income to the extent of basis, and have a carryover in basis or treat the amount in excess of basis as a distribution of current or accumulated earnings and profits.

3. Effect of Change in Status

The ability to receive previously taxed income tax free is personal and cannot be transferred.\textsuperscript{43} In the event that a shareholder sells, transfers his shares by gift or by operation of law, as in the case of the shareholder’s death, the successor will not be able to receive any distribution tax free.\textsuperscript{44} However, since the right is a personal one, the shareholder retains it in its entirety even though he transfers all of his stock and then later purchases new stock.\textsuperscript{45} The regulations also provide that the right to withdraw previously taxed income is lost upon termination of the Subchapter S election.

These rules are of questionable merit. The difficulty appears to result from a lack of legislative correlation between the provisions of the Internal Revenue Code providing for adjustments to basis and the Commissioner’s Treasury Regulations with respect to previously taxed income. A shareholder in a corporation which distributes all income currently rightfully receives no adjustment in the basis of his stock. However, a shareholder in a corporation which does not distribute all earnings receives a double benefit in the event of a sale or other disposition of less than all his shares. The earnings taxed to him increase the basis of the stock sold and thus decrease any taxable gain on the sale while still preserving in full his previously taxed income account as an incident to the shares retained.\textsuperscript{46}

\textsuperscript{42} Corporation S, which at the end of 1964 has $100,000 of accumulated earnings and profits, had current earnings and profits for 1965 of $30,000. Corporation S paid no dividends and the shareholders were taxed on a constructive dividend of $30,000. In 1966, it had current taxable income and earnings and profits of $20,000, made no cash distributions, but made a $50,000 property distribution. The shareholders would be taxed on the entire $50,000 property distribution as a distribution out of the accumulated earnings and profits. The shareholders would be taxed on an additional $20,000 constructive distribution of current taxable income. Neither distribution would qualify as a distribution of previously taxed income. Thus, the shareholders during 1965 and 1966 would have been taxed on $100,000 of income even though they had received only property of a value of $50,000.

\textsuperscript{43} Treas. Reg. \S 1.1375-4(e) (1959).
\textsuperscript{45} Id.
\textsuperscript{46} The opportunity for this shareholder to obtain a full distribution of previ-
The loss of the rights to withdraw previously taxed income upon transfer of the stock or termination of the election is arguably justifiable when it occurs upon the voluntary act of a shareholder, since the taxpayer is prevented from shifting tax-free income. However, the loss of this right due to an involuntary act, such as death, or due to an unintentional termination of Subchapter S status is particularly harsh. There seems to be little justification for imposing this rule in the event of the death of the shareholder. Since death is the one situation the timing of which the individual cannot control, it cannot be considered a part of a tax plan. Furthermore, neither the statute nor the legislative history exhibits any suggestions of support for the position of the Treasury Regulations limiting the right to withdraw previously taxed income upon termination of the election.

The termination of Subchapter S does not in any way compromise the reasons for permitting a shareholder to withdraw corporate earnings previously taxed to the same shareholder without current tax consequences. Moreover, even if a new election is made after termination, a shareholder's portion of the previously taxed income account is determined solely by reference to taxable years subject to the new election. Given these rules previously taxed income should be withdrawn if at all possible prior to any termination of election or transfer of stock.

4. Distributions of Cash and Reinvestment

Because of the various problems deriving from the absence of distributions of all of the corporation's current taxable income, it has been suggested that all of the current earnings be withdrawn each year, and particularly in year of termination of Subchapter S status. Only distributions of money will reduce the corporation's undistributed taxable income. A complete distribution of earnings is often impractical since a portion of a corporation's earnings may be required to be retained for business needs. To alleviate the cash requirements, previously taxed income is limited because the remaining shareholders are subject to a tax on a portion of the distribution.

If a shareholder receives a distribution of previously taxed income in excess of basis, such excess will be taxed at capital gains rates. This may occur when a shareholder has transferred part of his stock and thus has retained a large previously taxed income account compared to basis.

47 Other means of unintentional termination would include required election of new shareholders, the composition-of-income rule, the rule prohibiting a trust as a shareholder, and the one-class-of-stock rule. The Tax Reform Studies substantially reduces the risk of unintended termination.


49 The Treasury has proposed that for a one year period following termination, previously taxed income may be distributed. In addition, a special 120-day period would be provided upon the determination by the Commissioner, if an inadvertent termination had taken place. This distribution may be made in money or corporate obligations to any shareholder whether or not the shareholder was such during the election year. Tax Reform Studies 286.
the shareholders could loan the corporation the cash amounts so dis-
tributed. Such transactions raise at least three possible problems.

First, after a period of time, if the corporation becomes thinly
capitalized, loans could be regarded as a second class of stock which
would terminate the Subchapter S election. This danger has been
reduced by the recent modification of the Treasury Regulations
acknowledging that shareholder loans, as long as pro rata, will not result
in a second class of stock.

Second, if by pattern or by arrangement the shareholder consistently
loans the distributed funds to the corporation, the initial
distribution could be construed not as a distribution of money but a
distribution of property in the form of a corporate obligation. Since a
distribution of property does not reduce the undistributed taxable in-
come of the corporation, such a construction could result in a signifi-
cant tax recognition to the shareholder.

Third, such patterned or prearranged contributions could be dis-
regarded under an analogy not dissimilar to the step transaction doc-
trine, or on the ground that the transaction lacked economic reality.
Thus, in view of the possible unfavorable tax consequences, such a
patterned approach seems of questionable tax value.

It must be remembered that the need for a distribution of previously
taxed income only occurs if there are accumulated earnings and profits.
Thus, even the risk of loss of the previously taxed income account
may not prove harmful if the corporation has no accumulated earnings
and profits, since any distribution in excess of current earnings and
profits will be a return of capital.

Even if there is a previously taxed income account, the corpora-
tion with the consent of its shareholders may elect to treat a distribu-
tion as out of accumulated earnings rather than previously taxed
income. The election is made at the time the corporation files its
return, and applies only to one year. Normally, this procedure is not
attractive since it results in additional income to the shareholder.
However, in the event that the shareholder has other losses which
would not otherwise be utilized, the election might prove beneficial.
This election may also be used if there is only a small amount of
earnings and profits and not all shareholders have previously taxed
income. The Commissioner’s generosity in permitting such an election
is difficult to understand since it presumably will be utilized only when
it causes a favorable tax result.

50 CODE, § 1371(a)(4).
52R. PAUL, SELECTED STUDIES IN FEDERAL TAXATION 254 (2d Series 1938);
Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. United States, 364
53 CODE, § 301(c)(2).
C. DISTRIBUTIONS AFTER THE CLOSE OF THE TAXABLE YEAR

A Subchapter S corporation which desires to distribute its entire income each year may have computational difficulties, because at the end of its taxable year, it usually will not know the exact amount of its income. Therefore, it is not an uncommon practice for a Subchapter S corporation to wait until it has prepared its tax return to make a final distribution of its earnings. Such a distribution, if it were not for any special provisions,\(^5\) would be treated as if made out of the following year's earnings. Accordingly, the first year of the Subchapter S election would have an amount of undistributed taxable income.

In order to correct this situation, an amendment to the original provisions was adopted providing that a distribution of money made on or before the 15th day of the third month after the end of the corporation's year to a shareholder who is a shareholder at the end of the year, to the extent of that shareholder's undistributed taxable income for the preceding year was considered a distribution of previously taxed income.\(^6\) The provision applies only to cash distributions, continuing the Subchapter S discrimination against property distributions. The effect of this amendment is to permit such a distribution to be received tax free. Such treatment is particularly important in the case of a corporation whose Subchapter S election is terminated. Without the provision, a distribution made within a short period after the year in which the election was terminated would be a taxable distribution.\(^7\) A problem still remains if a transfer of stock is made after year-end and prior to a distribution, since the rules apply only to distributions to a person who was a shareholder at the close

\(^{5}\) Under prior law, distributions of the proceeds from the sale of a capital asset within 3½ months following the close of a taxable year, as authorized by the directors prior to year-end, were treated as distributions made on the last day of such previous year. CODE, § 1375(e).

\(^{6}\) CODE, § 1375(f). Corporation S elected Subchapter S treatment in 1966. In 1966, it had $10,000 of income and made distributions of $8,000. In February, 1967, it distributed $2,000. In 1967, it had income of $12,000, and it distributed $9,000 prior to year-end, in addition to the $2,000 distribution in February. The shareholders would be taxed in 1966 on $10,000 by reason of the $8,000 actual distribution and $2,000 constructive distribution. In 1967, the shareholders would be taxed on the actual distributions of $9,000 and on a constructive distribution of $3,000. The distribution in February would be treated as a distribution on the last day of 1966 of that year's earnings and would not be taxed.

\(^{7}\) If the Subchapter S election had terminated at the end of 1967, $3,000 could be distributed prior to March 15, 1968, without being taxed, as it would be treated as being out of previously-taxed income for 1967.

\(^{8}\) In the example in note 56, supra, if in January of 1967 the stock was sold to Shareholder B, he would be taxed on the $2,000 distribution in February. Note also that if the Subchapter S election were continued and $12,000 earned in 1967, $9,000 distributed in 1967, and the remaining $3,000 distributed in February of 1968, only $1,000 of the February, 1968, dividend would not relate back to 1967. This result would occur because $11,000 had been distributed in 1967, counting the February, 1967, distribution.
of the previous taxable year. Some care must be taken, therefore, in making transfers in these circumstances.

Planned transfers during this period can be avoided but there is still the possibility of a death during this period of time.

D. Earnings and Profits

Many of the adverse tax consequences to shareholders of Subchapter S corporations occur only if the corporation has accumulated earnings and profits, since a distribution in the absence of earnings and profits will not result in ordinary income tax. A Subchapter S corporation is more likely not to have accumulated earnings and profits than a non-electing corporation. Thus, an analysis of the earnings and profits becomes particularly important. As in Subchapter C, current earnings and profits may be in excess of taxable income if income includes such items as accelerated depreciation on real estate, life insurance proceeds, tax exempt interest and the differential between percentage and cost depletion. Accordingly, a corporation which holds tax exempt securities or assets subject to accelerated depreciation or percentage depletion should avoid Subchapter S status since capital generated by such assets cannot be distributed to the shareholder without tax.

The earnings and profits account is reduced by the amount of

---

58 The amendment does not cover previously-taxed income of years other than the immediately prior taxable year. Thus, a distribution cannot be made of all previously taxable income. If a distribution has been made in the immediately prior taxable year in excess of income, no distribution can qualify even though there is previously taxable income. This is a particular problem if the Subchapter S election is to be terminated. For example, Shareholder A, the sole shareholder of Corporation S, has $20,000 of previously-taxed income at the beginning of 1968. It is decided to terminate the Subchapter S election after the end of 1968 and Shareholder A desires to withdraw his entire previously-taxed income. However, this may not be done without knowing the amount of 1968 undistributable taxable income. If he estimates such income at $10,000, distributes $30,000 and it is actually $12,000, there is no way to distribute the other $2,000 in 1969. If there are accumulated earnings and profits, an excessive distribution will increase his tax.

60 In order for the dividend to qualify for this treatment, it must be paid within two and one-half months after the end of the year. Thus, declaration within that time is not sufficient. However, a transfer after the record date and before the distribution date should not disqualify the distributions as it will be to the individual who was a shareholder at year-end. There may even be an argument that a distribution qualifies, if a death occurs between the record date and distribution date. Although the strict language of a distribution "to a person who was a shareholder of such corporation at the close of such taxable year" would not be met, it seems strange to classify it as income in respect of decedent if it would not be income at all if the decedent had received it. This point, however, can be made on any other distribution of previously-taxed income.

61 Code, § 312; Treas. Reg. § 1.312-6 (1955); Treas. Reg. § 1.1373-1(g), Example (2) (1959).

62 Corporation S in 1969 has taxable income and current earnings and profits of $10,000, and $2,000 of tax-exempt interest income. As of December 31, 1967, Corporation S had no accumulated earnings and profits. If Corporation S distributed $12,000 to Shareholder A, such a distribution would be fully taxable as a dividend out of current earnings and profits.
the constructive distribution at year end.\textsuperscript{63} It is not reduced by a distribution of previously taxed income or a distribution after the close of the year which is in effect treated as a distribution of previously taxed income.\textsuperscript{64}

To insure that all taxable income is reflected on the shareholder's return as a constructive dividend, current earnings and profits are not reduced by any of the amounts which cannot be used to reduce undistributed taxable income, such as net operating loss carryovers, capital losses and the special corporate deductions.\textsuperscript{65} The earnings and profits account is also not reduced by the net operating loss for the year,\textsuperscript{66} since the loss is passed through to the shareholders. If the loss could also reduce earnings and profits, the shareholders would receive a double benefit.\textsuperscript{67}

There are three levels of absorption of current earnings and profits in a Subchapter S corporation. First, current earnings and profits are allocated to actual distributions of money.\textsuperscript{68} Second, any excess current earnings and profits over actual distributions of money are allocated ratably to the constructive dividend and actual distributions of property, other than money.\textsuperscript{69} Any remainder is allocated to distributions in exchange for stock.\textsuperscript{70} Apparently, the Treasury takes the position that accumulated earnings and profits may also be allocated to the constructive distribution of the undistributed taxable income.\textsuperscript{71} Thus, where there is a distribution of property other than money, accumulated as well as current earnings are allocated on the basis of relative fair market value.\textsuperscript{72}

In Subchapter C, earnings and profits are reduced only by the adjusted basis of property distributions. The Treasury has apparently deviated from this rule in Subchapter S by reducing earnings and profits by the fair market value of property distributions.\textsuperscript{73}

The absorption rules for earnings and profits present interesting permutations on otherwise simple computations of tax in case of a partial liquidation or redemption. Since in the year of a partial liquidation, no portion of the current earnings and profits would be allocated to a distribution in exchange for stock, the full constructive dividend

\textsuperscript{63} \textsc{Code}, § 1377(a) ; Treas. Reg. § 1.1377-1 (1959).
\textsuperscript{64} Treas. Reg. § 1.1375-4(a) (1959).
\textsuperscript{65} \textsc{Code}, § 1377(b).
\textsuperscript{66} \textsc{Code}, § 1377(c).
\textsuperscript{67} \textsc{Code}, § 1377(c). The shareholder receives a deduction to the extent of the loss under \textsc{Code}, § 1374(c).
\textsuperscript{68} Treas. Reg. § 1.1373-1(e) (1) (1959).
\textsuperscript{69} Treas. Reg. § 1.1373-1(e) (2) (1959).
\textsuperscript{70} Treas. Reg. § 1.1373-1(e) (3) (1959).
\textsuperscript{71} Treas. Reg. § 1.1373-1(g), Example (4) (1959).
\textsuperscript{72} This Regulation may give some clue to the mystery of Treas. Reg. § 1.316-2(b) (1955) which provides only for allocation to \textit{money} distributions.
\textsuperscript{73} Presumably absorption will follow allocation. Treas. Reg. § 1.1373-1(e) (2) (1959).
would be taxable as well as any amounts received in a partial liquidation. The constructive dividend increases the basis only of shares held at year end, and thus would not reduce the amount of gain on the prior distribution in partial liquidation.

E. BASIS IN STOCK AND DEBT

A shareholder's initial basis in stock of a Subchapter S corporation is determined in the same manner as the basis of stock in any other corporation. However, there is an annual adjustment in the basis of a shareholder's stock in a Subchapter S corporation to reflect the principal tax variations caused by the election.

The operation of the tax law, in general, results in the basis of a taxpayer's total assets increasing when gain or income is recognized and decreasing upon recognition of a loss. These concepts find application in the rules requiring an increase in the basis of the stock of a Subchapter S corporation by the shareholder's portion of the undistributed taxable income required to be included in his individual return, and a reduction in basis by that portion of the corporation's net operating loss which may be deducted on a shareholder's individual return. Likewise, a distribution of previously taxed income results in a decrease of basis, since there has been an increase in the shareholder's assets without an increase in taxable income.

The adjustments for undistributed taxable income and net operating losses are not dependent upon whether or not the inclusion in income results in tax to the individual or whether or not the individual can utilize the net operating loss. The basis in a shareholder's stock may not be reduced below zero. After net operating loss deductions have reduced basis of the shareholder's stock to zero, they are then applied against the basis

---

74 Corporation S has ordinary income of $100,000 and capital gain of $200,000 from the sale of half its assets for $300,000. A, who is the sole shareholder, had $100,000 basis for his stock. Corporation S distributes $300,000 in partial liquidation. A is taxed on a sale of half his shares for $300,000 resulting in $250,000 capital gain and a constructive dividend of $100,000 ordinary income and $200,000 capital gain. Shareholder A may well attempt to argue that the distribution was a dividend and not a partial liquidation so that he would be taxed on only $100,000 ordinary income and $200,000 capital gain.


76 Code, §§ 1376(a), 1016(a) (18). The Treasury has proposed that basis in the stock be increased or reduced by changes in earnings and profits of a Subchapter S corporation. Tax Reform Studies 287.

77 Code, §§ 1376(b), 1016(a) (18). For example, if $10,000 is paid for 100 shares constituting all of the outstanding shares of Corporation S, and during its first year the corporation sustains a $2,000 loss and during its second year has $3,000 of income, none of which it distributes, at the end of its first year the basis for the 100 shares would be $8,000 and at the end of the second year the basis would be $11,000.

78 Code, § 1.1375-4(a).

79 In the example in note 77, supra, if in the third year all of the corporation's earnings are distributed plus $1,500 of previously taxed income, then the basis would be reduced to $9,500.

of any debt owing the shareholder. If there is more than one indebtedness, the reduction will be allocated among the various items of indebtedness in proportion to their relative bases. In contrast to a shareholder's basis in his stock which is increased by undistributed taxable income, once the basis of indebtedness is reduced there is no statutory mechanism for increasing it. Thus, a shareholder may incur a substantial gain when the debt is later paid, even though such shareholder's stock may now have a basis substantially in excess of any previous losses. If the debt is evidenced by a debt instrument, as distinguished from an open account, the gain from the corporation's payment is capital gain and not ordinary income even though the reduction in the basis of this debt was reflected on the shareholder's return as an ordinary loss.

The computation of basis to determine gain or loss on a sale is more complicated than on the sale of stock of non-electing corporations due to the constant adjustment of basis. If stock is sold during a taxable year, the basis is not increased by the amount of profit earned during that year and prior to the date of sale. This result is consistent with the requirement that the buyer include the entire amount of income for the year in his return as the holder of the stock on the last day of the taxable year. Since net operating losses are apportioned throughout the year, a portion of the loss, but not necessarily that incurred before the date of sale, does reduce the basis. Since the amount of this loss is not known at the time of sale, it is not possible to know the basis and therefore the gain or loss on the sale.

If the buyer of Subchapter S stock already owned stock in the corporation, he must allocate a portion of any corporate undistributed taxable income among the shares equally, but must allocate his share of any net operating loss among his shares depending upon the length of time held during the year. The differences in basis treatment

---

82 Code, § 1373(b) provides for a reduction of first the shareholder's stock and then the basis in any indebtedness to the shareholder. However, § 1376(a) provides only that the basis in the stock shall be increased by the amount provided in the shareholder's income under § 1373(b).
83 Rev. Rul. 64-162, 1964-1 Cum. Bull. 304; Code, § 1232. Under the Treasury's proposals, any gain recognized on the redemption, disposition or sale attributable to reduction in basis by reason of a deficit in Subchapter S earnings would be treated as gain from the sale or exchange of a non-capital asset to the extent of the losses or the reduction of the earnings and profits at the time of the redemption or sale. Tax Reform Studies 290.
85 See text at note 14, supra.
87 Treas. Reg. § 1.1376-2 (1959). If a Corporation S has two shareholders, each of whom own 100 shares, and in the middle of a year in which there is a $4,000 net operating loss one shareholder sells all his shares to the other, the purchasing shareholder reduces the basis for the 100 shares he owned at the beginning of the year by $2,000 and the basis of the shares he acquired by $1,000.
result from the differences in determining his portion of such income or loss.

A Subchapter S corporation is much more likely than a non-electing corporation to distribute all of its earnings and to have occasion therefore to consider making distributions in excess of earnings and profits. Such a distribution, as with a non-electing corporation, results first in a reduction of basis and after basis is exhausted any additional amount is taxed as capital gain.\(^8\)

F. Net Operating Losses

Businessmen are often inclined to conduct business operations in the corporate form. Prior to the enactment of Subchapter S the corporate form was often not selected because of a desire to utilize personally the corporate losses. A major incentive for electing Subchapter S is that net operating losses of the corporation can be deducted by the shareholders on their individual returns.\(^9\)

In the early years of a business venture where losses may be likely, or in cases where an established corporation anticipates a loss and the protection of limited liability is important, Subchapter S may be attractive, since the corporate losses are a personal deduction, although personal assets are protected from corporate creditors.\(^9\) If a corporation later demonstrates earning power, the election may be promptly terminated. The net operating loss is determined by adjusting the corporation's taxable income to eliminate any special corporate deductions.\(^9\) The rule for allocating net operating losses takes into account shifts in ownership during the year and shifts in the amount of total shares outstanding. A shareholder's portion of the corporation's net operating loss is the aggregate of the corporation's daily net operating loss attributed on a pro rata basis to the shares held by such shareholder on each day of the corporation's taxable year.\(^9\) For purposes of this computation, a transferee is presumed to own the stock on the day of the transfer.\(^9\) Although the computation is more complicated than the simple apportionment of undistributed taxable income to those who are shareholders on the last day of the taxable year, it eliminates a shareholder's ability to transfer losses by a disposition of the stock before the year end. Once determined, the loss is con-

---

\(^8\) Code, § 301(c).
\(^9\) Code, § 1374(a).
\(^9\) Code, § 1374(c) (1). The impact of such a limitation can result in the elimination of a pass-through loss even though the corporation would have a loss if it were a regular corporation. Corporation S has $50,000 business income, $60,000 of business deductions and $10,000 of dividend income. A Subchapter C corporation would have an $8,500 loss ($60,000 gross income less $60,000 business deductions and $8,500 special corporate deductions), whereas Subchapter S status results in no loss to the shareholders.
\(^9\) Code, § 1374(c) (1).
\(^9\) Treas. Reg. § 1374-1(b) (3) (1959).
sidered a trade or business loss and, therefore, qualifies for net operating loss carryback and carryover on behalf of each shareholder.\textsuperscript{94}

In cases where a shareholder’s equity investment is supplemented by capital investment in the form of debt from third parties, a shareholder may have tax losses which exceed the basis in his stock and indebtedness to him. A loss in excess of basis may either be an economic loss, where the solvency of the corporation is in danger, or may be a paper loss caused by accelerated depreciation. Since a shareholder’s basis is not increased by his portion of the corporate indebtedness to persons other than himself,\textsuperscript{95} in order to preserve losses generated by accelerated depreciation shareholders might consider personally incurring third party indebtedness, and loaning the money to the corporation.

The normal rules in determining whether or not the corporation has a deductible loss will be applicable. Thus, a loss sustained in a hobby business will not be allowed merely because the hobby is conducted in a Subchapter S corporation.\textsuperscript{96}

II. THE CHARACTER OF THE INCOME

In determining the character of the income it should be recognized that the taxation of the shareholders of a Subchapter S corporation is basically according to corporate rules rather than according to partnership rules.\textsuperscript{97} Whereas in a partnership the income of the individual partners has the same character as it would to the partnership, in a Subchapter S corporation distributions are generally considered dividends except to the extent of the corporation’s capital gains.\textsuperscript{98} Thus, though the corporation may receive tax-free interest, it is not possible to distribute such income to the shareholder and have it retain its tax-free character. Dividends paid by a Subchapter S corporation will not qualify for the dividends-received exclusion even though they may be partially attributable to dividends received by the corporation.\textsuperscript{99}

A. CAPITAL GAINS AND LOSSES

Each shareholder includes in his income as a capital gain a pro rata share of the corporation’s capital gains.\textsuperscript{100} The portion is com-

\textsuperscript{94} CODE, § 1374(d).
\textsuperscript{95} CODE, § 1374(c) (2). The Treasury has proposed that any excess loss be allowed as a deduction in any succeeding taxable year of the same shareholder, to the extent that the shareholder’s basis in either debt or stock is increased. TAX REFORM STUDIES 289.
\textsuperscript{97} Treas. Reg. § 1.1372-1(c) 1959).
\textsuperscript{98} The Subchapter C rules, CODE, §§ 301-395, determine the nature of the income. In a partnership, the character passes through. CODE, § 705.
\textsuperscript{99} CODE, § 1375(b). Dividends treated as paid out of accumulated earnings and profits or current earnings and profits in excess of taxable income are eligible for the $100 dividend exclusion in the hands of the shareholders. Treas. Reg. § 1.1375-2 (1959).
\textsuperscript{100} CODE, § 1375(a) (1).
puted by determining the percentage that each shareholder's actual or constructive distributions for the taxable year of the corporation is to the total of such distributions, and applying this percentage to the total corporate capital gains.101

The amount of capital gain the shareholder may reflect is limited to the taxable income of the corporation.102 Thus, a shareholder may not report both a capital gain and a net operating loss. The shareholder must reduce the capital gain by the operating loss, and include only the remainder in income.103.

Every distribution during the year, including a distribution of property or constructive distribution, partakes of some proportion of any capital gains recognized.104 Furthermore, such a rule applies whether or not the distributee is a shareholder at the end of the corporation's calendar year. This rule has interesting applications in situations in which there have been shifts in shareholder ownership during the year. For example, if a shareholder sells his stock after receiving a dividend distribution and the corporation subsequently realizes capital gains, the selling shareholder is entitled to treat a part of that distribution as capital gains.105 Similarly, if the proceeds from a capital gain realized early in the taxable year are distributed, followed by a shift in shareholder ownership, the prior distribution, even though it may be traced to the proceeds from the sale giving rise to the capital gain, will not be taxed wholly as capital gain but will carry a proportion of the operating income of the corporation.106

The categorization of the nature of the gain is ordinarily determined at the corporate level.107 However, the character of the gain on the

102 CODE, § 1375(a) (1).
103 Treas. Reg. § 1375-1(c) (1959). Corporation S has two shareholders, A and B. During 1969, S has net long-term capital gains of $100,000, business income of $50,000 and current earnings and profits of $150,000. If S made no distributions during 1969, A and B would each consider $50,000 of their constructive distribution as net long-term capital gains.

104 Assume in note 104, supra, that A sold his stock to C on June 1, 1969, and S realized the capital gain on July 1, 1969. On April 1, S had distributed $30,000 to each of A and B. A and B each consider $20,000, \((\frac{100}{150} \times 30,000)\) as long-term capital gain and $10,000 as a dividend. B and C's constructive distribution of $45,000 each is $30,000 long-term capital gain and $15,000 ordinary income.

105 Corporation S is wholly owned by A. It has a capital gain in April of $30,000 and distributes the proceeds to A. On May 1, A sells his stock to B. Corporation S has $70,000 of ordinary income during the year. A is taxed on $9,000 of capital gain and $21,000 of ordinary income.

sale of property may not be changed by transferring it to a Subchapter S corporation.\textsuperscript{108} Thus, if there are gains in the sale of assets which would be ordinary income if held by the shareholders, or a substantial portion of them, the gain retains that character.\textsuperscript{109} However, the determination whether Section 1231 gain is capital gain is determined at the corporate, not the shareholder, level. If the corporation's 1231 gain exceeds its 1231 loss, this difference will be reported as capital gain by the shareholders and not offset against the shareholder's individual Section 1231 losses.\textsuperscript{110} Thus, the complete flow-through treatment which would be received by a partnership or sole proprietorship is not available to the Subchapter S corporation. Partners and sole proprietors could deduct the operating loss against ordinary income and realize the capital gain.\textsuperscript{111}

In the event the capital gain is taxed to the corporation, as is explained later, the amount of the tax paid by the corporation reduces the amount of capital gain allocated to the shareholders.

Capital losses do not present the same opportunity for tax avoidance as operating losses, since they cannot be deducted on the shareholder's individual return, but are deductible by an electing corporation, as in the case of a Subchapter C corporation, to the extent of capital gains.\textsuperscript{112} The five-year carryforward for excess capital losses should be equally applicable to an electing corporation and thus such carryforward would offset the corporation's capital gain in future years, including non-election years. Further, neither the statute nor the regulations prohibit capital losses incurred during non-election years from being carried forward and offsetting capital gains for election years. A corporation may not carry back any net capital loss incurred in an election year to any year, nor may a net capital loss incurred in a non-election year be carried back to an election year.\textsuperscript{113}

B. INVESTMENT CREDIT

If the Subchapter S corporation invests in property which qualifies for the investment credit, the amount of the investment credit is prorated among those who are shareholders of the corporation on the last

\textsuperscript{108} Id.

\textsuperscript{109} Id. The Treasury has proposed that capital gains treatment be denied to a shareholder owning more than 10% of the stock with respect to the allocable share of income from the disposition of property which would not have been treated as a capital asset in the shareholder's hands. Tax Reform Studies 284.

\textsuperscript{110} If Corporation S has $200 of \textcopyright A, § 1231, gain and Shareholder A has $200 of \textcopyright A, § 1231, loss, Shareholder A would reflect $200 of long-term capital gain on his return as well as an ordinary deduction of $200.

\textsuperscript{111} \textcopyright A, § 702.

\textsuperscript{112} The Treasury has proposed that a shareholder be allowed to reflect on his individual return his pro-rata share of the corporation's long-term and short-term capital loss in excess of capital gains earned by the corporation.

\textsuperscript{113} \textcopyright A, § 1212(a)(3).
day of the taxable year. A shareholder who may have been a shareholder at the time of the investment will not qualify for the investment credit unless he is also a shareholder at year end. This rule is inconsistent with the theory of Subchapter S that tax benefits of stock ownership are not transferable, and consequently permits planned tax avoidance. By transferring stock prior to the end of the year in which a corporation has made a substantial qualifying investment, the benefit of the investment credit may be transferred thus permitting purchase of a tax credit. The present rule is consistent with the rule which provides that the undistributed taxable income is taxable to individuals who are shareholders as of the last day of the taxable year. A more appropriate analogy would be to treat the investment credit in the same manner as net operating losses and thus allocate the credit on a daily basis or restrict the credit to the shareholders of record at the time of the investment.

A taxpayer's investment credit may not exceed the first $25,000 in taxes plus 50% of all taxes in excess of $25,000. This limitation applies to the shareholders of a Subchapter S corporation in determining the total amount of investment credit which may be taken. The investment credit on purchases of used property is limited to purchases of $50,000. In the case of a Subchapter S corporation this limitation is first applied at the corporate level.

The disposition by an electing corporation of Section 38 property prior to the expiration of the estimated useful life used in calculating the investment credit results in recapture, which is reflected in the income of the shareholders who received the benefit of the investment credit in the same manner as if they had made the investment and disposition. Recapture may occur even if the asset is not transferred if a shareholder's proportionate stock interest in the corporation is reduced below 66 2/3 per cent of his stock interest at the end of the fiscal year in which the investment occurred. On the date of such reduction, the Section 38 property purchased during the Subchapter S election ceases to be Section 38 property to the extent of the actual reduction in the shareholder's interest therein, even though the

114 Code, § 49 provides, however, that as a general rule no investment credit is allowable for property constructed, reconstructed or acquired after April 18, 1969.
115 See, e.g., Treas. Reg. § 1.1375-4(e) (1959), providing that a shareholder's right to non-dividend distributions is a personal right and not transferable.
116 Code, § 1373(b).
117 Treas. Reg. § 1.48-5(a)(2) (1964). A shareholder's allocable share of the used property purchased by the Subchapter S corporation must be added to his other purchase of used property in applying his individual $50,000 limitation.
119 Treas. Reg. § 1.47-4(a)(2) (1967). If property ceases to be Section 38 property to any extent, the percentage is 33-1/3 of the shareholder's proportionate stock interest on the date of the § 1.48-5 apportionment.
120 Corporation S has two shareholders. Shareholder A owns 80 shares and
reduction results from additional sales of stock by the corporation rather than from transfer by the stockholder. In computing a shareholder's percentage interest, in addition to the stock he owns directly, only indirect holdings in entities in which he has an interest and the basis of which is determined in part by the transferor's basis are attributed to him.\(^{121}\) Thus, stock transferred by a father to his son would not be attributed to him.

The investment credit provisions contain a trap for the unwary shareholders of an existing corporation who elect Subchapter S.\(^{122}\) Unless the corporation and shareholders file a consent with the return of the corporation for the taxable year immediately preceding the first election year, then all qualified property held by the corporation will cease to be Section 38 property on the last day of the corporation's taxable year immediately preceding the first election year.\(^{123}\) The consent must be signed by the corporation and by each of the persons who were shareholders on the first day of the first taxable year for which the election was effective or on the date of the election, whichever is later, and must be filed by the due date (including all extensions of time) of the return for the immediately preceding year.\(^{124}\) Each signer must agree to notify the district director of any disposition of investment credit property by the corporation and agree to be jointly and severally liable for the investment credit recapture.\(^{125}\) The tax law gives no special right of contribution but leaves the matter to state law. Shareholders making such a consent should consider making an agreement among themselves at the time of the consent for payment of the liability and perhaps giving rights of enforcement against the corporation's stock in the case of a failure to pay or such other device as may be appropriate.

Upon disposition of property for which the consent was filed, the amount of recapture is computed as if the disposition had been made immediately preceding the first taxable year for which the election was made, except that the actual useful life shall be considered to end at the time of the actual disposition.\(^{126}\) This provision is designed to

---

Shareholder B owns 20 shares. On January 1, 1968, Corporation S acquires $2,000 of Section 38 property with an 8-year useful life, the basis of which was apportioned at $1,600 to A and $400 to B under § 1.48-5, resulting in an investment credit of $112 to A and $28 to B. On January 1, 1969, A sells 40 shares to new Shareholder C. A's proportionate stock interest is reduced by 50% and the qualifying property ceases to be Section 38 property to the extent of $800. A must reflect $56 of investment credit recapture on his personal return for the calendar year of 1969.

\(^{121}\) Treas. Reg. § 1.47-4(a) (2) (iii) (1967).
\(^{122}\) Tax Reform Studies 284 has proposed that the election would not be treated as a disposition and recapture would be imposed on the corporation.
\(^{123}\) Treas. Reg. § 1.47-4(b) (1) (1967).
\(^{124}\) Treas. Reg. § 1.47-4(b) (2) (1967).
\(^{125}\) Id.
\(^{126}\) Id.
determine which shareholders are subject to recapture, since recapture is not dependent upon the taxpayer being a shareholder at the time the corporation sells the property. Thus if a shareholder makes such a consent and sells his stock while there is still investment credit recapture potential, he should attempt to get assurances that the corporation will not sell any of the property which will result in investment credit recapture. With respect to property purchased prior to a Subchapter S election and for which a consent was filed, reduction in a shareholder's stock holdings will not give rise to recapture.

The termination of a Subchapter S election is not a disposition of property resulting in recapture. On a latter disposition of the property by the corporation, however, the shareholders will be subject to recapture. This rule applies both to investments made during the Subchapter S election and prior to the election, if a consent was filed. A change in a shareholder's interest in the corporation even though it occurs after the Subchapter S election is terminated gives rise to recapture for investments made during the period of the election.

The rules with respect to the application of investment credit recapture to Subchapter S corporations, although they appear reasonable, are without statutory basis.

III. Special Situations
A. Corporation and Stockholders With Different Taxable Years

A corporation has complete freedom during its first taxable year to adopt any fiscal year. Thus, a Subchapter S corporation and its shareholders may have different fiscal years, in contrast to a partnership whose fiscal year must correspond to that of its partners. Accordingly, a new corporation planning to elect Subchapter S treatment should consider the ramifications of having the corporation on a fiscal year different from that of its shareholders.

The election of a corporate fiscal year different from that of the shareholder has certain advantageous tax consequences. First, there is the possibility of an initial deferral of income if the corporation has a fiscal year different than that of a shareholder's calendar year. In the year of incorporation or in the year of the initial Subchapter S election, tax on eleven months income may be deferred for twelve months, provided it is not distributed.

127 Treas. Reg. § 1.47-4(d) (1967).
128 Code, § 706(b); Treas. Reg. § 1.706-1(b) (1) (1956).
129 Note that the Commissioner of Internal Revenue under Treas. Regs. §§ 1.442-1(b)(1) and 1.442-1(c)(4), may refuse consent to the change of an existing corporation's taxable year if the change results in a substantial deferral of income to a shareholder of an electing Subchapter S corporation.
130 If Corporation S had a fiscal year ending January 31, 1968, if shareholders A and B are calendar year taxpayers, and if no dividends are paid during
tively minor, it may be helpful to a business with a short-term cash problem. However, if the shareholders have the corporation loan them funds and declare a dividend after the shareholders' year end to repay the loans, the loan could be construed to be a dividend, particularly in the absence of any expectation of repayment except from subsequent dividends.

Second, the election presents the opportunity for the shifting of shareholder income from one year to another by adjusting the timing of distributions in the various years. This power could be important to a shareholder with severe fluctuations in income from other sources, since proper timing would permit averaging of the shareholder's income. The same result is possible in a corporation which is not under Subchapter S if it declares dividends.

The election of a corporate fiscal year different from that of the shareholders can produce anomalous results for the unadvised shareholder. Cautious planning is required prior to making distributions in excess of the current year's income when the corporation and the shareholders have different years. Previously taxed income includes only items which have been taxed in a prior taxable year of the shareholder. If the corporation's fiscal year ends during the taxable year of a shareholder, the shareholder is taxed on the undistributed taxable income. Then, if during the same taxable year of the shareholder, the corporation makes distributions in excess of that year's earnings, such excess distribution will not be considered to be out of the preceding year's previously taxed income. If the shareholder has no other previously taxed income and the corporation has accumulated earnings and profits, both the undistributed taxable income for the fiscal year ending within the taxable year of the shareholder and the added distribution will be taxed as a dividend. Such a result can be avoided to the extent that a distribution occurs within two and one-half months after the end of the corporation's fiscal year.

1967, Shareholders A and B would not report the income for such fiscal year until their return due April 15, 1969. If, instead, Corporation S's taxable year ended on December 31, 1967, just one month earlier, Shareholders A and B would have reported the income for such year on their return due April 15, 1968.

131 Code, § 1375(d); Treas. Reg. § 1.1375-4(d) (1959).
132 Corporation S has $75,000 of taxable income for the fiscal year ending March 31, 1967, and $5,000 of taxable income for the fiscal year ending March 31, 1968. Corporation S has accumulated earnings and profits attributable to pre-Subchapter S earnings of $25,000. On November 1, 1967, Corporation S distributes $35,000 to Shareholder A. For Shareholder A's calendar year ending December 31, 1967, he must report a dividend of $105,000; $75,000 as March 31, 1967's, undistributed taxable income, $5,000 out of the current earnings for the fiscal year ending March 31, 1968, and $25,000 out of accumulated earnings and profits. The remaining $5,000 of the November distribution is applied against the shareholder's basis as provided in Code, § 301.

133 See, however, the text at note 56, supra.
Three practical problems arise if a shareholder, whose taxable year ends prior to that of the corporation, is required to file his return before corporate figures are available. First, if a distribution has been made, the shareholder may not be sure whether the distribution is a dividend. If the corporation has always been a Subchapter S corporation, it may have no accumulated earnings and profits and, therefore, the distribution will then be a dividend only if there are current earnings and profits. If a distribution is in excess of the current earnings to the date of the filing of the shareholder's return, whether or not the distribution is a taxable dividend depends on the corporation's later earnings. Even if there are current earnings in excess of the distribution at the time the return is filed, there may be the possibility of a large loss in the latter part of the year which would eliminate the earnings.

Second, the problem is further complicated if capital gains are realized by the corporation after the shareholder's tax return is filed, since a portion of any distribution previously made would be considered capital gain. Moreover, even if the corporation realized some capital gain prior to the distribution to the shareholder, the total amount to be reported as capital gain is still uncertain at the time the shareholder files his return, since the amount of capital gain allocable to the distribution depends upon the total income for the corporation's year.

If a corporation and a shareholder are on different taxable years and capital gain is realized, it is probable that the shareholder's return must be amended. Such action should be taken rather than merely correcting the error by adjusting the capital gain in the next year's distributions, since the next year may be adjusted on audit after the statute of limitations bars corrections for the prior year. Thus, if distributions have been made early in the year, the only remedy other than to request an extension is to make certain assumptions about the corporation's income for the year; then, if an adjustment has to be made, a refund claim or an amended return should be filed.

Thirdly, if there are distributions during a corporation's taxable

---

334 Code, § 6081. The Secretary or his delegate is empowered to grant reasonable extensions of time, not to exceed six months.

335 Such practical uncertainties could be alleviated by providing that capital gain is considered as part of the distributions during the corporation's year only for those distributions subsequent to realization of such capital gain. A shareholder's income would reflect all capital gains during his period of stock ownership, regardless of the relative timing of the taxable years. Thus, the individual who owned stock at the time of the sale should obtain the advantage of the capital gain. However, such a rule would result in difficulties in the situation where the capital gain exceeded both the dividend actually paid after it was realized and the constructive dividend at the end of the year. This could mathematically occur if distributions prior to the time of the capital gain were larger than the income earned at that time, or if the distributions and the constructive distributions did not equal the amount of the capital gain due to subsequent losses.
year of previously taxed income, it will be important to determine in which of the shareholder’s taxable years the distribution is made. Current earnings and profits are considered to be distributed pro rata in each distribution to a shareholder. Previously taxed income, however, is considered to have been distributed first. Later actual and constructive distributions determine what current earnings and profits are allocable to the earlier distribution. In turn, the amount allocable to the earlier distribution determines what amount of the distribution is taxable and how much previously taxed income is utilized.\(^1\)

The advantages of a corporation and a shareholder having different taxable years stem largely from the ability to accelerate or defer the shareholder’s reflection of taxable income. Such advantages are converted into liabilities if the corporation has present or prospective losses. In such a case the shareholder is generally interested in the immediacy of the reflection of the loss in his return. Since a shareholder can include only losses of a corporation’s taxable year ending within the shareholder’s year, a difference in taxable years defers the shareholder’s reflection of the loss. The complications are particularly acute if the shareholder sells his stock in the middle of a fiscal year in which there is a loss and his fiscal year ends before the corporate fiscal year. His basis for determining gain or loss will be affected by his share of the loss, the amount of which will be later determined.

The complexities of properly reporting actual distributions of income when the Subchapter S corporation and its shareholders are on different fiscal years is due primarily to the fact that a portion of the corporation’s taxable income must be reflected in the shareholder’s income prior to the end of the fiscal year of the corporation. Thus, as a policy matter, perhaps a Subchapter S corporation should not be allowed to elect a fiscal year different than that of the majority of its shareholders, at least without the permission of the Commissioner. The statute might be amended, in the interest of simplicity and consistency with the partnership provision.\(^2\) Such amendment should apply only prospectively to avoid ballooning of income in the year of change.\(^3\)

\(^{1}\) Assume that Shareholder A is on a calendar year basis and that Corporation S’s taxable year ends on April 30, 1968. A distribution of $40,000 is made in November of 1967 and $20,000 in April of 1968; Corporation S has $30,000 of taxable income, current earnings and profits for its year ended April 30, 1968 and Shareholder A has over $30,000 of previously-taxed income. $20,000 of the November, 1967, distribution is taxable but if no distribution had been made in April, $30,000 would have been taxable.

\(^{2}\) The Treasury has proposed for Subchapter S that an electing corporation’s taxable year end on the following December 31, unless there is a business purpose for a different year or all 10-percent shareholders have a taxable year other than a calendar year. Tax Reform Studies 277.

\(^{3}\) Existing Subchapter S corporations would be subject to “transitional rules” under the Treasury proposals. Tax Reform Studies 277.
Another alternative is to adopt the principles utilized in the case of other "flow-through" tax entities. If a partnership, trust or estate is on a different fiscal year from the partner or beneficiary, the partner or beneficiary includes the amount in income only in the year in which the partnership or trust ends without regard to when distribution is made.

B. Change in Stockholdings

Just as the tax treatment of a distribution may be affected by subsequent events in the same taxable year of the corporation but in a later taxable year of the shareholder, the tax treatment of a shareholder who transfers his stock after receiving a distribution will be affected by subsequent events occurring in the corporation's taxable year. The tax consequences of distribution prior to sale cannot be determined as of the date of the transfer but are dependent upon subsequent distributions and earnings.

If the selling stockholder received a cash distribution prior to his sale, his tax on the distribution depends upon whether the corporation's total cash distributions, some of which may occur after he sells, exceed the corporation's income for the year. The buyer will normally not want to have distributions in excess of current earnings and profits unless he has a previously taxed income account or the corporation has no accumulated earnings and profits. A more frequent occurrence may be a distribution of all profits prior to the date of the transfer, followed by a loss. The loss, though incurred by the buyer, will result in an unintended tax benefit to the seller by reducing the amount of the previous distribution subject to tax.

There are a variety of other tax consequences that can flow from a distribution of stock prior to the end of the corporate fiscal year. First, the capital gain component of a distribution will depend upon subsequent distributions and subsequent capital gains. It will not be to the buyer's advantage to recognize capital gains in the corporation's year in which the sale occurs as the seller will share in the benefits. Second, if the corporation has incurred a loss during the year of sale, subsequent operations during that year will determine the amount of the loss the seller can deduct, since such losses for the corporation are allocated on a daily basis. Third, if the seller receives a distribution of property and the corporation has no accumulated earnings and profits, the effect of the distribution will depend on whether cash distributions equal current earnings. Current earnings and profits

---

139 A owns all of the stock of Corporation S. On April 15, Corporation S distributes $50,000 to A and makes no other distribution. A sells his stock to B on May 1. Corporation S had a $30,000 capital gain in March and $70,000 in operating earnings. Corporation S could take a capital gain in December of $30,000. If the capital gain is not taken, $15,000 (30/100 x $50,000) of the distribution to A is capital gain. If the capital gain is taken, $26,666 (80/150 x $50,000) of the distribution to A is capital gain.
are allocated first to cash distributions and then proportionately between property and constructive distributions.\footnote{140}

A change in stockholdings can occur not only by the sale of stock by a shareholder but also by the issuance of additional stock by the corporation. The issuance of additional stock affects the allocation of a net operating loss, since it is deemed to be earned equally each day of the corporate year. Thus, a holder of ten per cent of the stock at the end of the year who held the same absolute number of shares throughout the year may be entitled to more than ten per cent of the loss, if he held more than ten per cent of the stock at some time during the year. Actual distributions of income present no problems of allocation since such distributions are taxed to the shareholders receiving the distribution. Likewise, constructive distributions are taxed to shareholders on the last day of the corporate year, regardless of ownership variations during the year. If the corporation sells stock shortly before year end, the buyers will be allocated a full year's share of constructive distribution.\footnote{141}

A reduction in stockholding either by shareholder sale or corporate issuance may give rise to an investment credit recapture and will decrease the shareholder's portion of investment credit attributable to qualifying property purchased at any time during the corporate year. As long as the shareholder and the corporation are on the same fiscal year, the shareholder will be in a position to determine the proper treatment of the distribution by the time his tax return is due. However, it seems anomalous for the treatment to depend on events occurring after he has sold his stock, and it is very difficult for a buyer or seller to know at the time of sale the tax consequences unless the sale is at the end of the year.\footnote{142}

C. ALLOCATION OF INCOME

Substantial income tax savings may be available to a sole proprietor who incorporates, elects Subchapter S, and then transfers stock in the corporation to his children who are in low tax brackets.

The Commissioner has several weapons to deal with this problem. First, the Treasury Regulations indicate that a donee or purchaser must acquire the stock in a bona fide transaction.\footnote{143} Moreover, family

\footnotetext{140}{See text at note 69, supra.} \footnotetext{141}{A owns 10,000 shares, or all the outstanding stock of Corporation S. The corporation has $15,000 of ordinary income for the year 1968. An additional 5,000 shares of stock is issued to B in December. B is allocated $5,000 of the undistributed income.} \footnotetext{142}{The Treasury’s proposal for tax reform would provide for an election by the corporation and the transferor to determine actual income up to the date of the transfer, in the case of death or a termination of interest. See Tax Reform Studies 283.} \footnotetext{143}{Due to the statute’s language, the Commissioner seems precluded from asserting the assignment of income principles of Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940). However, in Anton v. Commissioner, 34 T.C. 842 (1960), two fathers, each controlling shareholders...}
transactions will be "closely scrutinized." Such scrutiny requires a bona fide gift or transfer without ancillary agreements of any type to revest the benefits of ownership. If stock is transferred to minor children, but the father-donor retains a majority of the stock and does not declare dividends in excess of the tax liability of the children, an argument could be made that there has been no transfer of beneficial interest. However, as long as an actual transfer has occurred, the children will ultimately receive the benefit of the retained earnings through later distribution or upon sale.

Secondly, the statute authorizes the Commissioner to make allocations among shareholders who are members of the same family if necessary properly to reflect services rendered. The "family" of a shareholder includes only the spouse, ancestors and lineal descendants. Thus, questions of the reasonableness of salary can arise, but the sides will be reversed. The Commissioner will be arguing that the major officers should be receiving a higher salary and that a low salary was taken in an attempt to increase the corporation's income allocated to the various family members. Any salary found insufficient permits the Commissioner to reallocate the dividends paid or deemed constructively received to adequately reflect compensation for services.

Because of the difficulty of determining what is a reasonable salary, particularly among smaller businesses which do not have easily discernible comparables, a thicket of litigation is possible. Hopefully this power will not be used except in cases in which tax avoidance is clear. Certainly Subchapter S corporations in which the major stockholder takes a substantial reduction in salary after election are likely to be scrutinized under this provision. Such provision may well be analyzed under a pattern similar to that of a donee as a partner. In business in which capital is a major income producer as distinguished from services, the transfer of stock in a gift transaction should be sufficient to transfer the income ownership.

If there is excessive salary, or if other distributions are made to shareholders other than on a pro rata basis, a shareholder who receives less than his pro rata share will be considered to have waived his rights to such dividends, unless he can establish that the distribution was made

in a personal holding company, transferred by gift shares in the corporation after the declaration date but before the record and payment date. The Tax Court upheld the Commissioner's deficiency on the basis of Horst.


Such a device might be attempted in order to retain the maximum amount of cash in the corporation. However, since under state corporate law dividends must be pro-rata, a dividend only to the extent of the children's tax liability might not absorb the full tax liability of the father.

Code, § 1375(e).


without his consent.\textsuperscript{150} The total amounts distributable will be re-allocated pro rata among the family group. Presumably, such a reallocation results in gift tax consequences to the shareholder who received less than his pro rata share. At first, this power of allocation seems beyond the Commissioner's power to issue regulations without specific statutory authority. However, it is hard to determine any

Non-pro rata distributions are not in accord with corporate law and would require some type of consent by the family members. Thus, this type of provision is necessary to prevent tax avoidance by distributing the corporate income to the shareholder having the lowest tax rate. The intent may be to make an eventual pro rata allocation, and only to distribute earnings temporarily in a non-pro rata manner. This situation may arise innocently if the shareholders attempt to treat a Subchapter S corporation like a partnership and thus allocate the income for the year to the shareholders and permit the shareholders to withdraw it in accordance with their needs. But no matter how innocent the motive, a restructuring of the distributions made for tax purposes will be required.

A more difficult problem arises if shares are transferred to minors but it is desired to make distributions to the parent. If the Treasury Regulations were literally applied, the parent could contend that he should be taxed on only part of the distribution. The minor children would be taxed on the remainder and then treated as if they had made a gift to the parent. In view of the children's inability to make a binding waiver, this result does not seem proper. Such a plan is subject to the danger of the transfers to the minor children not being considered bona fide or even the termination of the Subchapter S election on the theory the minor's stock is a de facto second class.

IV. CORPORATE TAX

The one exception to the rule that a Subchapter S corporation pays no tax is the tax on certain capital gains.\textsuperscript{152} This provision was an attempt to close the loophole of the "one-shot elections." Typically, a corporation anticipating substantial capital gains would elect Subchapter S and sell certain of its assets. Any gain on the sale was not subject to the corporate tax and distributions of the amounts realized could then be made without regard to the limitations of the partial or complete liquidation provisions.\textsuperscript{153} After the sale, the election could

\textsuperscript{150} Treas. Reg. § 1.1375-3(d) (1959).
\textsuperscript{151} Treas. Reg. § 1.351-1(b) (1) and (2) (1955).
\textsuperscript{152} CODE, § 1378.
\textsuperscript{153} Corporation S realizes $200,000 on the sale of assets, with a basis of $50,000, and distributes the proceeds. The shareholders include $150,000 in their income as capital gains. Corporation S pays no tax on the sale. If Corporation S had not elected Subchapter S, the sale would be subject to a corporate
be terminated to avoid further shareholder tax on the corporation's continuing business income. If the election were continued after a sale on the installment method, shareholders could obtain deferral of the tax.\textsuperscript{154} Without the Subchapter S election, if the installment obligation were to be distributed in a complete liquidation, the shareholder would be required to report the difference between the value of the installment obligation and the basis of his stock.\textsuperscript{155} Further, in some instances, a corporation's basis in assets to be sold exceeded the shareholders' basis in their stock. With the election of Subchapter S, it was possible to recognize lower gain and make distributions of the gain.

In 1966, Congress recognized this unintended tax benefit,\textsuperscript{156} and provided that if the capital gains exceed 50\% of the Subchapter S corporation's taxable income, a 25\% tax is imposed on all capital gains in excess of $25,000, unless certain exemptions are met. In the event that the corporation's normal tax would be less than 25\%, the normal corporation tax rates are imposed.\textsuperscript{157} Any capital gains on which the Subchapter S corporation are taxable are treated as items of tax preference to the corporation and not to the shareholders.\textsuperscript{158}

The capital gains tax is not imposed if the Subchapter S election has been in effect for three preceding years or if the election has been in effect since the corporation was organized.\textsuperscript{159} However, a non-electing corporation may not acquire an electing corporation and rely on the acquired corporation's election time period nor may an electing corporation acquire a non-electing corporation and sell the latter's assets.\textsuperscript{160}

The amount of the undistributed taxable income of the corporation and the capital gain taxed to the shareholders is reduced by the tax imposed at the corporate level.\textsuperscript{161} The effect is the same as if the corporation had paid the tax and then distributed the remainder to the shareholders.

capital gains tax, and in the absence of a "contraction of the business," a "separate business" or a complete liquidation within one year, any amounts distributed to the shareholders, to the extent of earnings and profits, would be a dividend. Code, §§ 316, 331, 337 and 346.

\textsuperscript{154} If in note 153, supra, the assets were sold for a note of $150,000, the shareholders would report only the payments in each year. Code, § 453.

\textsuperscript{155} Assume in note 153, supra, Corporation S, a non-electing corporation, adopted a plan of liquidation under Code, § 337, sold all its assets for a note of $150,000, and then distributed the note within one year. Under Code, § 453(d), the liquidation is not a "disposition" requiring a tax at the corporate level, but the shareholders would be required to report the differences between the fair market value of the note and their basis in the stock as amounts received in exchange under Code, § 331. 


\textsuperscript{157} Code, § 1378(b)(2). Corporation S has capital gains of $60,000 and a net operating loss of $34,500. The tax would be the lesser of $15,000 (25\% of $60,000), or $2,740, the tax imposed by Code, § 11.

\textsuperscript{158} Code, § 58(d).

\textsuperscript{159} Code, § 1378(c).

\textsuperscript{160} Code, § 1378(c)(3).

\textsuperscript{161} Code, § 1375(a)(3).
The tax on capital gains did not completely eliminate the availability of “one-shot elections.” A sale of assets could be negotiated to take advantage of the exceptions to the tax.\textsuperscript{162}

V. CONCLUSION

The basic rules of taxation of the Subchapter S corporations and their shareholders reflects complexities apparently unintended by the initial proposals of the Congress. Many of the complexities are undoubtedly attributable to the need of these provisions to provide a form of taxation for other than a simple business. However, while the complexities and the deficiencies of Subchapter S are many, they do not warrant the abandonment of the benefits obtainable by careful examination of the tax consequences of both the corporation and the shareholder electing Subchapter S.

\[162\] If in note 154, \textit{supra}, the note was payable in $24,000 installments for the first 3 years, and the balance in the fourth year, presumably \textit{Code}, § 1378, would not apply.