Eligibility, Election and Termination under the Subchapter S Revision Act of 1982

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The Subchapter S Revision Act of 1982 (hereinafter referred to as Act),¹ which generally became effective for taxable years beginning after December 31, 1982,² is the most comprehensive overhaul of the eligibility, election and termination provisions in the twenty-five year history of subchapter S.³ The Act makes sweeping changes in nearly every area of subchapter S: including treatment of income, deductions and credits for the S corporation and its shareholders;⁴ treatment of corporate distributions;⁵ selection of a

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² I.R.C. §§ 1361-79 (1982) (codified generally at I.R.C. §§ 1361-79 (1982)) [hereinafter cited as Act]. References to “I.R.C.” indicate Title 26, United States Code. Code Sections which have been revised or replaced by the Act will be referred to as “former I.R.C.”

³ Important provisions governing passive investment income became effective for taxable years beginning after December 31, 1981. A new tax on “excess net passive income” of the S corporation is applicable to taxable years beginning after this date. I.R.C. §§ 1375, 1366(f)(3) (1982). For a brief explanation of this new tax, see infra note 4. The revised treatment of termination, for situations in which there is excess passive investment income, takes into consideration certain earnings and profits at the close of each of three consecutive taxable years and the amount of passive investment income during each of these years. The earliest of these years will be the taxable year beginning after December 31, 1981. I.R.C. § 1362(d)(3)(A)(i), (iii) (1982). For a detailed explanation of these provisions, see infra text accompanying notes 178-184. Finally, the effective dates of the new provisions regarding the fringe benefits available to employees of S corporations are varied and depend upon the circumstances. I.R.C. § 1372 (1982). All other provisions of the Act apply to taxable years beginning after December 31, 1982. Act § 6(a).

⁴ The Act imposes a new tax upon “excess net passive income.” This tax is only imposed if the S corporation has accumulated earnings and profits, derived when it was a C corporation, at the close of a taxable year during which it also has gross receipts consisting of more than 25% passive investment income. If these two requirements are met, the tax is computed by multiplying the excess net passive income by the highest rate of tax set forth in I.R.C. § 11(b)(1982). Net passive income is defined as passive investment income less the deductions “directly connected with the production of such income.” I.R.C. § 1375(b)(2) (1982). Excess net passive income is defined as net passive income multiplied by a fraction whose numerator is the amount by which the passive investment income for the taxable year exceeds 25% of the gross receipts, and whose denominator is the passive investment income for the taxable year. I.R.C. § 1375(b)(1) (1982). In any event, the excess net passive income is not to exceed the corporation’s taxable income for the taxable year. I.R.C. § 1375(b)(1)(B) (1982). See infra text accompanying notes 178-99.

The Act makes important changes in the rules governing the taxation of an S corporation’s shareholders. As with a partnership, the S corporation is required to state separately
corporate taxable year; treatment of fringe benefits; treatment of expenses owed to shareholders; administrative determination of all tax liabilities on the corporate level; and miscellaneous matters.

All items of income, loss, deduction or credit whose separate treatment could affect the tax liability of any shareholder. I.R.C. §§ 1363(b), 1366(a)(1) (1982). The character of each item shall be determined as though the shareholders realized it directly from the source from which it was realized by the corporation, so that it is characterized at the shareholder level. I.R.C. § 1366(b) (1982). As under prior law, the amounts of losses and deductions that pass through to an individual shareholder cannot exceed his basis in stock and debt, but, in a departure from prior law, any loss or deduction disallowed because it exceeds the shareholder's basis in stock and debt may be indefinitely carried over. I.R.C. § 1366(d)(2) (1982).

5. S corporations with no earnings and profits that make distributions to their shareholders will cause the shareholders to include in their gross income as gain from the sale or exchange of property, only that amount of the fair market value of the distribution (whether in cash or in property), that exceeds the adjusted basis of their S corporation stock. I.R.C. § 1368(b) (1982). If the S corporation has accumulated earnings and profits, that portion of the distribution which does not exceed the newly created "accumulated adjustments account," I.R.C. § 1368(e)(1) (1982), will be treated as though the S corporation had no earnings and profits, and that portion of the distribution which remains will be treated as a dividend to the extent that it does not exceed the accumulated earnings and profits. That portion of the distribution that exceeds the accumulated earnings and profits would again be treated as though the S corporation had no earnings and profits. I.R.C. § 1368(c) (1982). If the S corporation distributes any property with respect to its stock (other than its own obligation) and the fair market value of the property exceeds its adjusted basis, the S corporation will recognize gain to the same extent as if it had sold the property at its fair market value. I.R.C. § 1363(d) (1982).

6. The former flexibility available in the selection of the S corporation's taxable year, so as to achieve a deferral of tax for the shareholders has been substantially eliminated. Under the Act, the S corporation's taxable year must end on December 31, unless the corporation can establish a "business purpose" for any other date. I.R.C. § 1378(b) (1982).

7. For purposes of determining employee fringe benefits, the S corporation is to be treated as a partnership and any two percent shareholder is to be treated as a partner. I.R.C. § 1372(a) (1982).

8. In the case of an S corporation shareholder (as well as certain persons related to him), owning, directly or indirectly, at least two percent of the outstanding stock of the corporation the S corporation may not deduct from its gross income any of a variety of certain deductible expenses until the shareholder is required, pursuant to his method of accounting, to include the payment in his gross income, provided that he is not required to include the payment in his gross income unless paid. I.R.C. § 267(f) (1982).

9. The tax treatment of any subchapter S item is to be determined at the corporate level, and S corporation shareholders are required to treat items in a manner consistent with the S corporation's treatment of the same items unless the shareholder notifies the Secretary of the inconsistency. In the event of any administrative or judicial proceedings involving the S corporation's taxes, each shareholder is to be given notice of, and a right to be heard in, such a proceeding. I.R.C. §§ 6241-43 (1982). These new audit provisions were designed to generally follow the new audit provisions governing partnerships after the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of U.S.C.).

10. Other provisions include the computation of the oil and gas depletion allowance in a manner comparable to that used in the case of partnerships. I.R.C. § 613A(13) (1982). Numerous other provisions conform other sections of the Internal Revenue Code with the Act's
The Act creates the "S corporation,"\textsuperscript{11} which is a "small business corporation" (hereinafter referred to as SBC), which has made a subchapter S election.\textsuperscript{12} Any corporation that is not an "S corporation" is a "C corporation."\textsuperscript{13} Like its predecessor, the former "electing SBC,"\textsuperscript{14} the S corporation is the only corporation permitted to elect not to be taxed on its income, except as provided in subchapter S.\textsuperscript{15} Subchapter S imposes a corporate income tax upon certain tax preferences,\textsuperscript{16} capital gains,\textsuperscript{17} and excessive passive investment income.\textsuperscript{18} Dispensation from the double taxation afflicting C corporations\textsuperscript{19} comes at the price that the S corporation's shareholders must personally account for the corporation's income, losses, deductions and credits on their returns.\textsuperscript{20}

The Act, especially in the areas of eligibility, election and termination, is intended to serve two distinct purposes: 1) to eliminate technical traps for the unwary taxpayer upon whom might be imposed unintended burdens through provisions such as those causing unexpected retroactive loss of a corporation's subchapter S election; and 2) to eliminate opportunities for sophisticated taxpayers to gain unintended benefits. Such unintended benefits had been available through manipulation of the same provisions to cause a retroactive loss of a corporation's subchapter S election when ad-

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\item changes in terminology, such as the introduction of the term, "S corporation." I.R.C. § 1361(a) (1982).
\item I.R.C. § 1361(a)(1) (1982).
\item Id.
\item I.R.C. § 1361(a)(2) (1982).
\item Former I.R.C. § 1371(b) (1976).
\item The S corporation is not subject to the taxes imposed by chapter 1 of the I.R.C., except as in § 58(d) and in subchapter S. I.R.C. § 1363(a) (1982).
\item If the S corporation is subject to a § 1374 tax on certain capital gains, it may also be subject to a § 56 tax on certain tax preference items, to the extent attributable to gains subject to the § 1374 tax. I.R.C. § 58(d) (1982).
\item I.R.C. § 1374 (1982).
\item I.R.C. § 1375 (1982). For a brief discussion of the tax on excess net passive income, see supra note 4.
\item Normally, a corporation is taxed upon the realization of income, and then the shareholders themselves are later taxed upon the distribution of this income in the form of dividends to them. Various commentators have suggested different approaches to the double taxation problem through the integration of the corporate and individual income taxes. Subchapter S taxes the corporation's income directly to the shareholder. Other approaches would give the corporation a deduction for dividends paid or the shareholders a credit for part of the corporation's taxes. See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 1.08 (4th ed. 1979) (suggests several alternative approaches to double taxation and compiles a bibliography).
\item I.R.C. § 1366(a) (1982).
\end{enumerate}
vantageous to the shareholders.\textsuperscript{21}

When considered with those provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter referred to as TEFRA)\textsuperscript{22} which seek to achieve parity between the S corporation and the C corporation in terms of qualified deferred compensation plans,\textsuperscript{23} the Act ensures that the S corporation will receive serious consideration as a form of business or investment entity by a broader range of taxpayers than in the past. Both the Act and TEFRA advance the original goal of subchapter S, which was to “eliminate the effect of the Federal tax laws on the form of organization adopted by certain small businesses.”\textsuperscript{24} The Act does so by simplifying and relaxing the eligibility requirements for an SBC,\textsuperscript{25} easing the requirements for termination of the subchapter S election by revocation,\textsuperscript{26} eliminating events that previously caused termination of the subchapter S election,\textsuperscript{27} restricting the scope of other terminating events,\textsuperscript{28} and ameliorating the harshness of certain inadvertent terminations.\textsuperscript{29}

Conversely, the Act also revises many eligibility, election and termination provisions in a manner that may prove unfavorable to the taxpayer. It strengthens certain election requirements\textsuperscript{30} and, more importantly, eliminates the taxpayer’s ability to cause a ret-


\textsuperscript{23} For taxable years beginning after December 31, 1983, TEFRA establishes parity among qualified preferred compensation plans of C corporations, S corporations and Keogh or HR-10 plans, for partnerships, in terms of the maximum contributions or benefits allowable. S. REP. No. 494, 97th Cong., 2d Sess. 621.

\textsuperscript{24} S. REP. No. 1622, 83d Cong., 2d Sess., \textit{reprinted in} 1954 \textit{U.S. Code Cong. & Ad. News} 4621, 4752. In 1954 Congress enacted former I.R.C. § 1361 (1964), which permitted partnerships and proprietorships to elect to be taxed like corporations. At the same time, the Senate passed a bill that represented the precursor of subchapter S, but the bill died in the House. The rationale for both former § 1361 and the original Senate bill was to enable businesses “to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence.” S. REP. No. 1983, 85th Cong., 2d Sess., \textit{reprinted in} 1958 \textit{U.S. Code Cong. & Ad. News} 4791, 4876. Former I.R.C. § 1361 was repealed when Internal Revenue Service statistics disclosed that fewer than 1,000 business entities had elected to be taxed as corporations. S. REP. No. 1007, 89th Cong., 2d Sess., \textit{reprinted in} 1966 \textit{U. S. Code Cong. & Ad. News} 2141, 2149.

\textsuperscript{25} \textit{See infra} text accompanying notes 34-145.

\textsuperscript{26} \textit{See infra} text accompanying note 177.

\textsuperscript{27} \textit{See infra} text accompanying notes 176, 200-01.

\textsuperscript{28} \textit{See infra} text accompanying notes 178-99.

\textsuperscript{29} \textit{See infra} text accompanying notes 210-14.

\textsuperscript{30} \textit{See infra} text accompanying notes 146-59.
reactive termination of the subchapter S election. The Act may also provide the Secretary of the Treasury with new legislative authority, should he seek to renew the subchapter S debt-equity dispute by recharacterizing certain debt as a second class of equity and thereby deprive some S corporations of their status as an SBC.

This article, which assumes a basic familiarity with subchapter S, compares the eligibility, election and termination provisions of the Act with prior law.

I. ELIGIBILITY REQUIREMENTS

The Act maintains the structure of the prior law by retaining most of the eligibility requirements for a subchapter S election in the definition of an SBC. Prior to the Act, an SBC was defined as a domestic corporation, which was not a member of an affiliated group, and which did not have: 1) more than twenty-five shareholders; 2) a shareholder not an individual, unless it was an estate or one of four types of trusts; 3) a nonresident alien shareholder; or 4) more than one class of stock. After the Act, an SBC must be a domestic corporation, which is not an ineligible corporation, and which does not have: 1) more than thirty-five shareholders; 2) a shareholder not an individual, unless it is an estate or one of four types of trusts; 3) a nonresident alien shareholder; or 4) more than one class of stock. An "ineligible corporation" comprises members of affiliated groups and four other types of corporations whose special treatment for income tax purposes makes

31. See infra text accompanying notes 207-09.
32. See infra text accompanying notes 109-45.
33. For a general discussion regarding the operation of subchapter S, see B. Brrrker & J. Eustice, supra note 19.
34. Former I.R.C. § 1371(a) (Supp. V 1981). As defined in I.R.C. § 7701(a)(4) (1982), a domestic corporation is one "created or organized in the United States or under the law of the United States or of any State."
35. Former I.R.C. § 1371(a) (Supp. V 1981). As defined in I.R.C. § 1504(a) (1982), an affiliated group is a chain of certain specified corporations along with a common parent corporation, where a requisite level of interrelated stock ownership exists among all of the corporations, and between at least one corporation and the parent corporation.
36. Although the statute reads, "and," the clear meaning is to prohibit a small business corporation from having any one of these features.
40. See supra note 36.
them unsuitable for subchapter S taxation. This latter group includes insurance companies subject to tax under subchapter L, financial institutions to which sections 585 or 593 apply, domestic corporations making a section 936 election to receive a tax credit for certain taxes paid as the result of conducting a trade or business within a possession of the United States and present or former domestic international sales corporations.

Although the old and new definitions of an SBC appear similar, the Act makes a number of important changes. The Act increases the maximum number of shareholders allowed, makes three significant changes in the Qualified Subchapter S Trust created by the Economic Recovery Tax Act of 1981 (hereinafter referred to as ERTA), one change affecting all foreign trusts, and two changes affecting the one-class-of-stock limitation. The only provision that the Act leaves unchanged is the prohibition against nonresi-

43. In Rev. Rul. 74-344, 1974-2 C.B. 273, the Commissioner ruled that a life insurance company subject to tax under subchapter L did not qualify as a small business corporation under prior law, due to inconsistencies in tax treatment caused by the application of both subchapters.
44. Drafters of the Act relied upon the Commissioner's reasoning in Rev. Rul. 74-344 to exclude from subchapter S certain financial institutions whose special bad-debt deductions under I.R.C. §§ 585 or 593 (1982), would be passed through to their shareholders. Senate Report, supra note 21, at 3261, states that "[t]hese corporations are entitled to certain deductions not generally allowed to individuals."
45. Senate Report, supra note 21, at 3261, states that the treatment of possession corporations contained in the Act is a continuation of prior law. As with the financial institutions, however, the drafters cite no authority for this assertion. I.R.C. § 936 (1982), provides that certain domestic corporations conducting trade or business in a U.S. possession, excluding the U.S. Virgin Islands, may take a credit against their U.S. income tax based upon the tax imposed upon their non-U.S. source taxable income in the U.S. possession. Evidently, Congress objected to the pass through of this possessions tax credit to S corporation shareholders. However, the Senate Report, supra note 21, at 3267, lists the foreign tax credit at I.R.C. §§ 901-08 (1982), as one of the credits of the S corporation to be passed through to the shareholders. There is no duplication of benefits principle at work here, since no corporation may take advantage of both the foreign tax credit and the possessions tax credit. I.R.C. §§ 901(g)(2), 904(b)(4) (1982).
46. The domestic international sales corporation is generally permitted to escape tax and pass through its income to shareholders under its own set of rules set forth at I.R.C. §§ 901-97 (1982). I.R.C. § 992(d) (1982) previously prohibited the S corporation from being treated as a DISC. The Act merely reinforces this restriction.
47. See infra text accompanying notes 52-69.
49. See infra text accompanying note 108.
50. See infra text accompanying notes 109-45.
dent alien shareholders.\textsuperscript{51}

\section*{A. Thirty-five Shareholders}

Congressional intent has always been to limit subchapter S to "small" corporations.\textsuperscript{52} Congress has consistently determined the relative size of a corporation, for purposes of subchapter S eligibility, by the number of its shareholders\textsuperscript{63} rather than by other factors such as the amount of its capital.\textsuperscript{64} Whether the increase to thirty-five as the maximum number of shareholders allowed for a subchapter S corporation will have any practical impact is questionable, especially in view of the fact that a great majority of recently filed corporate tax returns disclose no more than seven shareholders.\textsuperscript{65} Congress intended however, for the new ceiling of thirty-five shareholders to have significance apart from a mere policy determination of how many shareholders an SBC may have. The legislative history states that the new ceiling "corresponds to the private placement exemption under Federal securities law."\textsuperscript{66} Precisely how these two limits correspond is uncertain, as substan-

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\item \textsuperscript{51} I.R.C. § 1361(b)(1)(c) (1982).
\item \textsuperscript{52} The right to elect the treatment provided under the new subchapter [S] was limited to small business corporations in part because of the complexity involved in passing the earnings of a corporation through to its shareholders where the stock of the corporation is held by a widely diversified group of shareholders, and in part because it was thought that only the relatively small corporations were essentially comparable to the partnership or proprietorship where the earnings are taxed to the owners rather than to the business organization.\textsuperscript{53} 
\cite{S_REP_No_830_88th_Cong_2d_Sess_reprinted_in_1964_U.S_CODE_CONG_AD NEWS_1673_1820}
\item \textsuperscript{54} In many respects, an analysis of a corporation's capital structure would be a far more accurate indication as to its relative size. However, probably due to the administrative inconvenience which would result from such an approach, it has never received serious consideration as an alternative or supplement to the more arbitrary, but far more easily applicable shareholder limitation. Cf. I.R.C. § 1244 (1982) (certain capital loss treated as ordinary loss on sale or exchange of stock of corporations with not more than $1,000,000 of capital contributions and paid-in surplus).
\item \textsuperscript{56} \textit{Senate Report, supra} note 21, at 3259 (footnote omitted).
\end{itemize}
tially different rules for computing numbers of investors for these two purposes render ineffectual any attempt to equate the two limitations.57 The efforts to correspond the maximum number of S corporation shareholders with the maximum number of private-placement purchasers is meaningful though, as an indication of a legislative intention to place the S corporation on a greater degree of parity with a partnership and to continue to eliminate federal tax incentives for selecting one form of doing business or organizing investments over another.58

Nothing in the Act or its accompanying legislative history suggests any other changes in the prior statutory, administrative or case law governing the determination of the number of shareholders. Thus, as a general rule, a shareholder will remain any person "who would have to include in gross income dividends distributed with respect to the stock of the corporation,"59 although the distributions from an S corporation will no longer be treated as dividends.60 The beneficial owner of the stock is ordinarily regarded as the shareholder.61 Although they do not satisfy the requirement that the shareholder be an individual,62 and regardless of the number of beneficial owners, corporations,63 partnerships,64 and most trusts65 may be single shareholders. The Act does not alter the provisions that a husband and wife, and their estates, be treated as one shareholder.66 The taxpayer may not use the attribution rules

57. For example, various special securities rules and doctrines, such as the doctrine of integration, which generally ties in prior offerings with present offerings for certain purposes, could greatly affect the actual number of purchasers involved in any offering and significantly reduce it from 35.
58. See supra note 24.
62. See supra text accompanying note 41.
64. The original legislative intent was to prevent a partnership from being an S corporation shareholder: "if a corporation, partnership, or trust becomes a shareholder . . . , the election is thereby terminated." S. REP. No. 1983, supra note 24, at 5006. The I.R.S. has long maintained that a partnership is not a qualified S corporation shareholder. Rev. Rul. 59-235, 1959-2 C.B. 192. At least as much a conduit as a simple trust, the partnership could be the next candidate for qualification as an S corporation shareholder.
65. See infra text accompanying notes 70-108.
66. I.R.C. § 1361(c)(1) (1982). The Act changes the heading of former I.R.C. § 1371(c) (Supp. V 1981) which read, "Stock owned by husband and wife." Although the substantive provision has not changed, the new heading more accurately states, "Husband and wife treated as 1 shareholder." The former heading represented a vestige of an earlier provision which in fact required that for the husband and wife to be treated as a single shareholder
governing constructive ownership of stock to reduce the number of shareholders by merging family-member shareholders into a single shareholder. Nor may the taxpayer satisfy the limit by dividing a single corporation with more than thirty-five shareholders into two or more separate corporations, each with thirty-five or fewer shareholders. An S corporation may have more than thirty-five shareholders in any one taxable year, provided that at any one point during that year it has no more than thirty-five shareholders.

B. Trusts as Shareholders

The Act introduces four changes to prior law governing the types of trusts authorized to be S corporation shareholders. Three changes pertain only to the Qualified Subchapter S Trust (hereinafter referred to as QSST) created by ERTA. The fourth change prohibits foreign trusts from being S corporation shareholders.

As a general rule, the S corporation shareholder must be a natural person. Subchapter S, when first enacted, prohibited all trusts from being shareholders, probably for the purpose of avoiding administrative inconvenience in the allocation of income, loss, deductions and credits among various trust beneficiaries. The Tax Reform Act of 1976 authorized grantor trusts, voting trusts and testamentary trusts as S corporation shareholders. ERTA broadened the grantor-trust category to include any deemed-owner trust, provided the deemed owner was a third party with excessive control over the income or corpus. ERTA also included within the category of deemed-owner trusts the new Qualified Subchapter S Trust. Thus, the following four types of trusts have been qualified to serve as S corporation shareholders: 1) any trust deemed owned by a United States citizen or resident individual with exces-

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70. See infra text accompanying notes 86-107.
71. See infra text accompanying note 108.
72. Technical Amendments Act of 1958 § 64.
73. Grantor trusts are treated at I.R.C. §§ 671-77, 679 (1982). These are trusts in which the grantor or settlor of the trust is taxed on the trust income because of his excessive control over the trust corpus or income.
75. I.R.C. § 678(a) (1982).
76. ERTA § 234.
sive control over trust income or corpus;\(^\text{77}\) 2) any trust described in 1) above for sixty days following the transfer of the stock, or, in certain cases, two years after the death of the deemed owner;\(^\text{78}\) 3) a testamentary trust for sixty days after the S corporation stock is transferred into the trust;\(^\text{79}\) and 4) a voting trust.\(^\text{80}\)

For each of the above trusts, subchapter S designates the identity of the S corporation shareholders. The deemed owner is the shareholder in the case of all deemed-owner trusts, except the QSST.\(^\text{81}\) The income beneficiary of the S corporation stock is the shareholder in the case of the QSST.\(^\text{82}\) After the death of the deemed owner, or the beneficiary of the QSST, his estate is treated as the S corporation shareholder.\(^\text{83}\) A similar rule treats the estate of the testator as the S corporation shareholder when the stock is held by a testamentary trust.\(^\text{84}\) Finally, each beneficiary of a voting trust is designated as the S corporation shareholder.\(^\text{85}\)

The QSST is a special trust that is treated as though it is a deemed-owner trust.\(^\text{86}\) For a trust to become a QSST, the beneficiary or his legal representative\(^\text{87}\) must irrevocably elect, separately as to each S corporation whose stock is held by the trust,\(^\text{88}\) to be treated as a QSST. If no election is made, the subchapter S election terminates when the S corporation stock is transferred into the trust. The purpose of the election is to replace the trust with the beneficiary as the S corporation shareholder. As the S corporation shareholder, the QSST beneficiary must then account for his share of the corporate income, losses, deductions and credits.

A trust must satisfy several requirements before it can elect to be a QSST. Under ERTA, the QSST was required to contain restrictions generally designed to ensure that the income beneficiary

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\(^{78}\) I.R.C. § 1361(c)(2)(A)(ii) (1982). The two-year period applies if all of the trust corpus is included in the deemed owner's gross estate. Regarding the need for the trust to dispose of the stock, see Kanter, Planning and Pitfalls on the Disposition of Subchapter S Stock Held in a Grantor Trust, 50 J. Tax'n 284 (1979).
enjoyed a substantial present interest whose value was readily ascertainable. Thus, one could easily determine his share of income, losses, deductions and credits. Evidently in furtherance of this goal, the terms of the QSST had to provide that, at any time, there be only one income beneficiary and that his interest would terminate only upon the earlier of his death or the termination of the trust. At that time, if the beneficiary still lived, the trustee had to distribute the QSST assets to the beneficiary. Furthermore, any corpus distributed during the term of the trust had to be distributed to the current income beneficiary. The Act revised the requirements to permit "the possibility of multiple beneficiaries after the death of the current beneficiary." The only requirement unchanged by the Act is that the QSST own stock in at least one S corporation.

The Act also amended the former requirement that "all of the income [be] distributed currently to one individual" to read: "all of the income (within the meaning of section 643(b)) [be] distributed (or required to be distributed) currently to 1 individual. . . ." The qualification of the word "income" introduces to subchapter S the concept of "fiduciary accounting income," which is explicitly borrowed from subchapter J, governing the taxation of the income of estates and trusts. The parenthetical addition after "distributed" is also borrowed from subchapter J. Each clause therefore will bring with it, to some extent, a well-accepted meaning.

The introduction of "fiduciary accounting income" adds meaning to the previously unqualified word, "income." Fiduciary accounting income is income as defined by the trust agreement and applicable local law. However, if a trust agreement departs "fundamentally" from the concepts of income as set forth in local law—such as by treating the gain from the sale of all of the trust corpus as income

91. Id.
92. Id.
93. Senate Report, supra note 21, at 3261.
98. I.R.C. § 651(a) (1982).
or treating ordinary cash dividends as principal—the trust treatment of an item will be ignored in favor of the more logical treatment offered under local law.\textsuperscript{101} Shortly after ERTA was passed, one commentator, expressly assuming that "trust income" meant "fiduciary accounting income," mentioned the planning possibilities in drafting the QSST agreement to require the accumulation of S corporation receipts allocable to principal.\textsuperscript{102} The accumulated receipts allocable to corpus would then be taxed under the usual subchapter J formula, at the lower rate of the trust, and distribution of these receipts to the grantor of the trust after termination would be tax free.\textsuperscript{103} Additional flexibility could be gained by allocating as much of the on-going trust expenses either to income or corpus, depending upon the results sought.

The purposes of the addition of the phrase "(or required to be distributed)" are fairly clear. As originally drafted, the QSST requirements were satisfied as long as a trustee made current distributions of income, even though the terms of the trust agreement may not have required him to do so. The apparently unintended result of this provision was to permit the trustee to disregard the "irrevocable" election of QSST status and terminate retroactively the subchapter S election for all shareholders, by exercising his discretion in any one year not to distribute the trust income currently.\textsuperscript{104} Also, the new language prevents an inadvertent termination due to the trustee's failure to distribute income currently as long as the trust agreement required him to do so.\textsuperscript{105}

It is difficult to determine what effect these changes will have on the QSST. In many respects, the third-party deemed-owner trust affords the grantor greater flexibility than does the QSST, especially when a minor is the income beneficiary. This is because of the QSST's requirement that the income be distributed currently.\textsuperscript{106} The QSST poses a serious disadvantage to the beneficiary as well. Consider the harsh result visited upon the income beneficiary who must account for S corporation income even though the S corporation makes no actual distribution to the

\begin{itemize}
\item \textsuperscript{101} Treas. Reg. § 1.643(b)-1 (1956).
\item \textsuperscript{102} Kaney, New Tax Law Opens the Door to Gifts of Subchapter S Stock in Trust to Minors, 8 EST. PLAN. 342, 343 (1981).
\item \textsuperscript{103} I.R.C. §§ 641, 651, 102 (1982).
\item \textsuperscript{104} Kaney, supra note 102, at 343.
\item \textsuperscript{105} Thus, the trustee who is under a duty to distribute the income currently, but negligently fails to do so, will not jeopardize the subchapter S election as long as the trust agreement in fact required him to make such a distribution.
\item \textsuperscript{106} Kaney, supra note 102.
\end{itemize}
QSST, and thus the trust makes no actual distribution to the beneficiary. The beneficiary, not the QSST, is treated as the S corporation shareholder, so he, like any other S corporation shareholder, must account for income not necessarily received by him. At least the grantor or third-party deemed owner usually has sufficient control over trust income or corpus to generate sufficient actual distributions to him to cover his tax liability. The QSST beneficiary generally has no similar power and, once he has made his election, may be in a difficult position if the S corporation is not making actual distributions and he cannot either terminate the election or require an actual distribution.

The final change regarding trusts made by the Act is to prohibit foreign trusts from being S corporation shareholders. The Senate Report states succinctly that “[f]oreign trusts, like foreign corporations and nonresident aliens, will not be eligible shareholders.”

C. One Class of Stock

The Act preserves the prohibition against more than one class of stock within an SBC. But, true to the dual purposes of the eligibility provisions of the Act, it makes two revisions to the one-class-of-stock requirement, one of which may aid the taxpayer and one of which may not.

The Act provides that a corporation will not be treated as having more than one class of stock “solely because there are differences in voting rights among the shares of common stock.” This provision is somewhat misleadingly headed “Differences in common stock voting rights disregarded.” Of course, this is not so. The statute provides only that such differences will not be the sole basis for finding the existence of a second class of stock. It is unlikely, however, that any difference in voting rights could have become, in the presence of other factors, the determinative factor supporting a finding of a second class of stock. A Revenue Ruling and the Treasury Regulations have long provided that, as

107. A partner must also account for income possibly not received, I.R.C. § 702(c) (1982), as must the recipient of a consent dividend from a personal holding company or from accumulated earnings. I.R.C. §§ 561(a), 565 (1982).

108. Senate Report, supra note 21, at 3261.


110. See supra text accompanying note 21.


112. Id..


114. Treas. Reg. § 1.1371-1(g) 1967-1 C.B. 219. The second class of stock must be both
to issued and outstanding stock, shares "not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation" create more than a single class of stock.\textsuperscript{118} Thus, if the S corporation stock is differentiated in terms of its dividend rights or liquidation preferences, any difference in voting rights would be superfluous, as the presence of either different dividend rights or liquidation preferences violates the one-class requirement.

The Revenue Ruling and the Treasury Regulations have been widely disregarded by the courts as far as they pertain to differences in voting rights.\textsuperscript{119} Furthermore, the Secretary has stated that while disproportionate voting rights arising out of articles of incorporation would create a second class of stock, shareholders' agreements "not involving the corporation's formal ownership structure," would not.\textsuperscript{117}

In view of the reduced status for the last ten years of disproportionate voting rights as a determinative factor in the one-class requirement, the Act does not represent a major revision of the S corporation eligibility requirements. It does, however, substantially reduce the possibility that shareholders' agreements resulting in the creation of disproportionate voting rights will create a second class of stock, and it may lead, as the heading suggests, to the abandonment of disproportionate voting rights as a factor in determining the one-class issue.

The Act also creates a "straight debt safe harbor" in order that

\begin{itemize}
\item issued and outstanding to cause a loss of SBC status; it is not enough that it is merely authorized, or that it is treasury stock.
\item 115. Id.
\item 116. Parker Oil Co. v. Commissioner, 58 T.C. 985 (1972). The Tax Court held invalid that part of the Treasury Regulations and Revenue Ruling regarding voting rights. The Court reasoned: "the overriding purpose of the requirement that only one class of stock exist in a corporation . . . is to avoid complexities in taxing income to shareholders with different preferences as to the distribution of profits." Id. at 990. The Parker decision, in which three judges dissented, distinguished with some difficulty the case of Pollack v. Commissioner, 392 F.2d 409 (5th Cir. 1968), which had been decided by the Fifth Circuit, affirming the Tax Court, less than five years earlier. In Pollack, the court found a violation of the one-class requirement where the articles of incorporation had been amended to create four classes of stock with varying rights to elect directors. The Parker court distinguished Pollack on the bases that, in Parker, the differences in voting rights were created by independent proxy agreements between the shareholders and not included in the articles of incorporation and that the taxpayers in Pollack "apparently did not argue that the treasury regulations failed to reflect congressional intent." 58 T.C. at 991. Although confronted with something less than overwhelming authority, the Secretary acquiesced to the result only in Parker. Rev. Rul. 73-611, 1973-2 C.B. 312.
\end{itemize}
taxpayers may be assured that S corporation debt meeting the statutory requirements will not be recharacterized as a second class of stock. Straight debt is "any written unconditional promise to pay on demand or on a specified date" a specific sum of money; provided that the interest rate and due dates are not contingent upon profits, the borrower's discretion or "similar factors," that the debt cannot be converted into stock, and that the creditor is an authorized S corporation shareholder. A legislative safe harbor often signals the end to a current controversy, but the straight debt safe harbor could provide the Secretary with an opportunity to renew the debt-equity litigation in this area. The debt-equity controversy in subchapter S concerns the issue of whether S corporation "debt" is in fact "equity," and, more importantly, whether this recharacterization means that the S corporation has more than one class of stock. If it has, it is consequently no longer an SBC, and loses its subchapter S election.

The government has long been unsuccessful in its efforts to establish the existence of a second class of stock through this means. In Gamman v. Commissioner, the Tax Court held invalid a treasury regulation that treated as a second class of stock all debt instruments that in fact represented equity. The court reasoned that in former I.R.C. section 1376, Congress anticipated the presence of debt in the S corporate capital structure, and refused to extend the law to disqualify all S corporations whose authorized debt is actually stock. The Court then held that, even if the debt were stock, it was not a second class of stock because it was held in direct proportion to the shareholder's stockholdings and could not have given the noteholders any rights (which they waived in any case) over themselves as shareholders. Under the facts, the money advanced to the S corporation as loans was as at risk as the capital previously invested. The court concluded that Congress created the one-class requirement, in part, "to avoid the complexities involved in passing the earnings of a corporation through to its stockholders where the stock of the corporation is held by a widely diversified group of stockholders with different rights."

122. 46 T.C. 1 (1966).
123. Id. at 8.
124. Id. at 7-8.
Four years later, in *Stinnett v. Commissioner*, the Tax Court rejected the Commissioner's "thin capitalization" arguments where the S corporation was in fact thinly capitalized. The court declined to approach the issue by determining whether notes were in fact stock. It stated that the notes did not confer voting rights or rights to participate in the growth of the company, but only the right to be repaid the principal without interest. The court then held the new treasury regulation, which had been amended after *Gamman*, invalid. The invalidated regulation was an attempt to recast so-called "debt" as a second class of equity, even if held disproportionately to the stockholdings. Noting that the issue was not whether the notes were stock for the purpose of applying other provisions of the tax laws, the court concluded that the only issue was whether the corporation had formally issued a second class of stock, which it had not.

Finally, three years later, in *Portage Plastics Co. v. United States*, the Seventh Circuit, in an *en banc* decision reversing a divided opinion by a three-judge panel, applied the *coup de grace* to the Commissioner's thin-capitalization arguments. In that case, shareholders held notes bearing interest of five percent of the net profit. The corporation was thinly capitalized and the subject notes were subordinated to bank loans. The risk of default was extremely high. The court found it unnecessary to review the question whether the notes were equity, but restricted itself to the question whether the traditional debt-versus-equity criteria, as outlined above, were determinative of the one-class issue. Citing as authority two recent Fifth Circuit decisions, the court held these criteria to be inapplicable largely because they did not serve the purpose of the one-class limitation, which was "to avoid the administrative complexity in the allocation of income which would

125. 54 T.C. 221 (1970).
126. The Tax Court in *Stinnett* defined what it referred to as the essence of a thin-capitalization doctrine as follows: "An instrument which upon its face constitutes evidence of indebtedness and does not carry with it rights or privileges commonly attributed to stock is generally deemed to be an "equity" interest by coupling the debt with a formal stock interest held by the same or a related person." Id. at 230.
127. 486 F.2d 632 (7th Cir. 1973).
128. Portage Plastics Co. v. United States, 470 F.2d 308 (7th Cir. 1972).
129. 486 F.2d at 634.
130. Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972); Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972).
131. 486 F.2d at 636-37.
result with more than one class of stock." The court, recognizing that the thin-capitalization tests were developed to counter tax avoidance in other areas of corporate income tax, suggested that the government abandon its "blunderbuss" approach to the problem through application of the thin capitalization tests. Some years later, the Secretary added to the treasury regulations, section 1.1371-1(h): "Relation section 385." That section authorizes the Secretary to prescribe regulations in order to provide guidelines for future determinations of whether a debtor-creditor or corporation-shareholder relationship exists in a given factual case. However, the subsection has been left "reserved" as a silent threat since its promulgation.

Much of the Act is the product of the legislative report prepared by the Staff of the Joint Committee on Taxation on April 30, 1980 (hereinafter referred to as Staff Report). One of the few Treasury recommendations that was not incorporated into the Staff Report was what is now the straight debt safe harbor. Among the reasons cited in the Staff Report for not endorsing such a proposal was inadequate consideration at the time of the question of:

whether it is appropriate to make legislative provision for a second class of stock which in some respects is more limited in scope than the cases which hold that a subchapter S corporation can have both common stock and another class of equity without violating the one class of stock rule.

In other words, should Congress overturn those courts which had refused to adopt the Internal Revenue Service's argument that, if S corporation debt is recharacterized as equity, it necessarily creates a second class of stock?

In the Treasury Staff Comments that were not endorsed by the Staff Report, the Secretary argued in favor of construing the one-class limitation in conjunction with the debt-equity approach taken elsewhere in the Internal Revenue Code. Noting the "judicial

133. Id. at 637.
134. 486 F.2d at 639.
137. Subchapter S-Elections, supra note 55.
138. Other reasons for rejecting the Treasury recommendations for creating a straight debt safe harbor included increased complexity of administration, and problems caused by assignment of income among family members through the use of debt. Subchapter S-Elections, supra note 55, at B-705 n.2.
139. Id.
reluctance to disqualify subchapter S corporations because of the one class requirement," the Treasury representatives wrote:

A rational regulatory scheme under section 385 should apply the debt/equity classification throughout the Code, including the status of securities issued by subchapter S corporations. But, as the case law suggests, the loss of subchapter S qualification is often a harsh result when a corporation issues nominal debt that is treated as equity under section 385. It is a result that flows from the current subchapter S [one-class] requirement . . . ; it should not be a classification problem under section 385. Therefore, the problem should not be solved by overriding the rules of section 385. Rather, the solution is to change the subchapter S qualification requirements directly by amending the statute to allow a second class of stock with delineated characteristics.\(^{140}\)

They concluded that if an instrument fails to come within the preferred safe harbor but, after application of section 385, does not appear to be a preferred security, it will be treated as debt and will not jeopardize the subchapter S election. If, however, it is outside the safe harbor and, after application of section 385, it appears to be a preferred stock, it “will be treated as an impermissible class of stock and the corporation will lose its subchapter S status.”\(^{141}\)

The Senate Report to the Act states that “[t]he classification of an instrument outside the safe harbor rules as stock or debt will be made under usual tax law classification principals [sic].”\(^{142}\) Significantly, none of the legislative history expressly takes the next step and says that, if classified as a preferred stock under section 385 provisions, the “debt” necessarily represents a second class of stock. Nevertheless, by creating a safe harbor, the Act provides the Secretary with the argument that an S corporation with stock mislabeled as debt could have avoided the loss of its subchapter S election by using the straight debt safe harbor. Additionally, the Act eliminates much of the harshness of the result by eliminating the retroactive termination of the subchapter S election.\(^{143}\) Taxpayers should have a better idea as to the Secretary’s intentions when the government publishes proposed legislative regulations, which are to be promulgated under the Act.\(^{144}\) For now, the ques-

\(^{140.}\) Subchapter S-Elections, supra note 55, at B-711.
\(^{141.}\) Id. at B-712.
\(^{142.}\) Senate Report, supra note 21, at 3260.
\(^{143.}\) See infra text accompanying notes 207-09.
\(^{144.}\) I.R.C. § 1361(c)(5)(C) (1982).
tion must remain open as to how these regulations will satisfy the Congressional admonishment that "these rules will treat the instrument in such a way as to prevent tax avoidance, on the one hand, and also to prevent unfair, harsh results to the taxpayer."\(^{145}\)

II. Subchapter S Election

The Act makes few important changes in the procedures governing the election by an SBC to be an S corporation. Consistent with prior law,\(^ {146}\) all shareholders on the day of the election must consent to the election.\(^ {147}\) The election may still be made by the fifteenth day of the third month of the taxable year,\(^ {148}\) or during the taxable year preceding that in which it is to take effect.\(^ {149}\) An election made after the first two and one-half months of the taxable year is treated as having been made for the following taxable year.\(^ {150}\)

In the event that an SBC elects on or before the fifteenth day of the third month, the Act requires that during the prior two and one-half months the corporation has met the SBC requirements at all times, and all persons who were shareholders during that period join in the consent. If these requirements are not met, the Secretary will treat the election as effective for the following year.\(^ {151}\) Previously, the election would have been effective even though the corporation was unqualified during the first seventy-five days, or a shareholder from the first seventy-five days failed to consent, provided that on the date of the election the corporation was qualified and all current shareholders consented to the election.\(^ {152}\)

The express purpose of this new requirement is to "prevent any allocation of income and loss to pre-election stockholders who either were ineligible to hold subchapter S corporation stock or did not consent to the election."\(^ {153}\) Presumably, the two and one-half month period for an election to relate back to the beginning of the taxable year will continue to commence with the earliest of the acquisition of assets, appearance of shareholders, or commencement

\(^{145}\) Senate Report, supra note 21, at 3260.
\(^{151}\) I.R.C. § 1362(b)(2) (1982).
\(^{152}\) Treas. Reg. § 1.1372-1(a), 1978-2 C.B. 64.
\(^{153}\) Senate Report, supra note 21, at 3262-63.
of business.\footnote{154} Shareholder’s consent is required from each person in a tenancy in common, joint tenancy or tenancy by the entirety. This includes, of course, the husband and wife,\footnote{155} even though they are treated as only a single shareholder for purposes of counting shareholders.\footnote{156}

Although consents must be filed at the time of the election,\footnote{157} the current treasury regulations give the district director or service center director the discretion to extend the time for filing a consent if the failure to file timely was due to “reasonable cause” and if “the interests of the Government will not be “jeopardized.”\footnote{158} Congress intends for the same discretion to be exercised under the Act.\footnote{159}

III. TERMINATION OF SUBCHAPTER S ELECTION

The Act makes major changes in the law governing the termination of subchapter S elections. Prior to the Act, an election was terminated if one of five events occurred: 1) a new shareholder affirmatively refused to consent to a subchapter S election within sixty days after acquiring his stock; 2) the shareholders unanimously revoked the subchapter S election; 3) the S corporation’s “gross receipts” consisted of over twenty percent “passive investment income;” 4) the S corporation derived more than eighty percent of its gross receipts from non-U.S. sources; or 5) the S corporation ceased to be an SBC.\footnote{160}

In many situations under prior law, the subchapter S termination provisions produced unfair and unworkable results. For example, revocation was unavailable if a single shareholder refused to consent.\footnote{161} Revocation was not available at all during the first taxable year of the election.\footnote{162} Yet, a single shareholder could force a termination of the subchapter S election, even in the first year of the election, by selling a single share of stock to a corporation\footnote{163} or

\footnote{154} Treas. Reg. § 1.1372-3(a) (1969).
\footnote{155} Id.
\footnote{156} See supra text accompanying note 66.
\footnote{157} Treas. Reg. § 1.1372-3(a), 1969-2 C.B. 246.
\footnote{158} Treas. Reg. § 1.1372-3(c), 1969-2 C.B. 246.
\footnote{159} SENATE REPORT, supra note 21, at 3262 n.6.
\footnote{160} Former I.R.C. § 1372(e) (1976).
\footnote{161} Former I.R.C. § 1372(e)(2) (1976).
\footnote{162} Id.
\footnote{163} This would cause a termination under former I.R.C. § 1372(e)(3) (1976), because the S corporation would cease to be an SBC. See supra text accompanying notes 34-37.
to a natural person who could affirmatively refuse to consent to the subchapter S election within sixty days from the date of the transfer.\textsuperscript{164} Also an important difference existed between termination by revocation and termination by any other means. Unless the revocation occurred in the first month of the S corporation's taxable year, termination by revocation did not take effect until the following taxable year, but termination due to affirmative refusal to consent,\textsuperscript{165} loss of SBC status,\textsuperscript{166} excessive foreign income\textsuperscript{167} or excessive passive investment income\textsuperscript{168} caused the termination to operate retroactively from the first day of the taxable year in which it took place.\textsuperscript{169} The former retroactive termination provisions thus conferred upon the S corporation shareholders an unintended benefit. It allowed them to determine, near the end of a taxable year, whether operation as a C corporation for the past year would have resulted in a reduced tax liability. If so, they could easily effect a retroactive termination of the subchapter S election by, for example, selling shares of stock to a corporation.

The Act eliminates most of the inequities of retroactive terminations by providing that most terminations be prospective, taking effect either on a pro rata basis from the date of the terminating event or as of the commencement of the following taxable year.\textsuperscript{170} The Act also revises the above five termination events as follows:

1) new shareholders no longer have the right to refuse affirmatively to consent to a subchapter S election;\textsuperscript{171} 2) a mere majority of the shares is now required to revoke a subchapter S election;\textsuperscript{172} 3) the twenty percent limit on passive investment income has been raised to twenty-five percent and is applicable only under certain circumstances;\textsuperscript{173} 4) the eighty percent limit on non-U.S. source gross re-

\textsuperscript{164} Former I.R.C. § 1372(e)(1) (1976).
\textsuperscript{165} \textit{Id.}
\textsuperscript{166} Former I.R.C. § 1372(e)(3) (1976).
\textsuperscript{167} Former I.R.C. § 1372(e)(4) (1976).
\textsuperscript{168} Former I.R.C. § 1372(e)(5) (1976).
\textsuperscript{169} See provisions regarding the effective date of terminations, \textit{supra} notes 164-68.
\textsuperscript{171} Former I.R.C. § 1372(e)(1) (1976), has no counterpart in the Act.
\textsuperscript{172} I.R.C. § 1362(d)(1)(B) (1982). The Staff Report recommended lowering the requisite number of shareholders to revoke an election from 100% to only 66 2/3%. This was done in order to require agreement on the part of both majority and minority shareholders in order to revoke the election. \textit{Subchapter S-Elections, supra} note 55 at B-706. Presumably, Congress decided that there was really no reason to require the agreement of minority shareholders regarding this type of corporate decision.
ceipts has been repealed;¹⁷⁴ and 5) the cessation of SBC status continues to be a termination event, although it now operates prospectively.¹⁷⁵

The first change made by the Act to a terminating event is to eliminate the provision permitting a new shareholder to refuse affirmatively to consent to the subchapter S election within sixty days of the stock transfer, and thereby terminate the election. The legislative history is silent as to the reasons for the repeal of this provision, but, given its demonstrated potential for abuse, the Staff Report explanation is convincing:

[T]here is little or no justification for a new shareholder, who knows or should know he is acquiring stock of a subchapter S corporation, to have the power (described by some as blackmail power) to terminate that corporation's election. More appropriately, his acquisition of that stock should be viewed as a consent to subchapter S treatment.¹⁷⁶

The second change to a terminating event made by the Act is to reduce the number of shareholders necessary to revoke an election from 100% to a number holding a majority of the shares. Again, although the legislative history is silent, the Staff Report explained that "the present law ... [is] too restrictive. ... [A] minority shareholder should not always be able to prevent a revocation desired by most of the shareholders and that some percentage below 100 would be more reasonable".¹⁷⁷

The third revision of the terminating events is of interest to a wide range of taxpayers. The Act eliminates the passive investment income test for all S corporations unless they have: 1) "subchapter C earnings and profits at the close of each of three consecutive taxable years," and 2) gross receipts consisting of over twenty-five percent passive investment income for each of the same three years.¹⁷⁸ To prevent the churning of assets to increase non-passive income, gross receipts from the sale of capital assets, other than stock and securities, will be taken into account only to the extent of the capital gain net income from those receipts.¹⁷⁹

Other than for this change, the Act leaves undisturbed the prior

¹⁷⁷. Id.
meaning accorded to "gross receipts," i.e., gross receipts, not income, modified to include only the gains from the sale or exchange of stock or securities and to exclude any distributions received by the S corporation from the liquidation of another corporation controlled by the S corporation.180 "Passive investment income" is still defined as "gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities."181

The Act introduces the category of "subchapter C earnings and profits," which are the accumulated earnings and profits from any year in which a subchapter S election was not in effect.182 Only taxable years beginning after December 31, 1981, are to be taken into account in determining whether the S corporation has accumulated subchapter C earnings and profits for three consecutive years and whether the S corporation, during each of those years, exceeded the new twenty-five percent limit on passive investment income.183 The Act answered in two cases the question of whether "passive income" derived from active business falls within the definition of passive investment income. It specifically exempts from passive investment income interest on any notes acquired in the ordinary course of trade or business from the sale of inventory, and gross receipts received by certain corporations derived from the "active and regular conduct of a lending or finance business."184

The Act's treatment of passive investment income represents a major departure from prior law. Formerly, the subchapter S election of any S corporation, with only a minor exception for certain new corporations,185 was retroactively terminated if, for any taxable year, over twenty percent of the corporation's gross receipts

181. Id.
184. I.R.C. § 1362(d)(3)(D)(ii), (iii) (1982). The former statutory subsection responds to the problem of the S corporation which sells a substantial part of its inventory and acquires purchase money notes. The interest paid on these notes would otherwise be excessive passive investment income due to its reduced gross receipts. The latter subsection represents a legislative overruling of the result reached in Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975), in which an S corporation that actively conducted a trade or business was found to have received passive investment income as a result of interest received.
185. The exception applied to the first two taxable years of operation for the S corporation if, in each year, its passive investment income was less than $3,000. In such a case, the subchapter S election would not be terminated. It was thought that the S corporation was merely commencing operations and had not yet generated the active business or investment income that it intended to produce. Former I.R.C. § 1372(e)(5)(B) (1976).
constituted passive investment income. The original justification contained in the legislative history for the passive investment income limitation was:

When the "passthrough" type of tax treatment was provided for corporations, Congress decided to limit the availability of this treatment to small businesses actively engaged in trades or businesses. Therefore, it denied this treatment to corporations with large amounts of passive income.\textsuperscript{186}

Congress expressed an unwillingness to permit the "incorporated pocketbook" to enjoy the same benefits of qualified deferred compensation plans that C corporations enjoy.\textsuperscript{187} However, new restrictions placed upon the maximum deferred compensation benefits available to shareholder employees of S corporations have relieved the pressure to maintain the passive investment income limitation. A Senate Report concluded that:

Probably the principal reason why this limitation on passive investment income was adopted was to reduce the incentive to incorporate one's investment activities merely to obtain tax deferral benefits accorded to pension, profit-sharing, and similar plans. However, with the imposition by the Tax Reform Act of 1969 of the H.R. 10-type of limitation on pensions, etc., paid to a shareholder-employee of a subchapter S corporation, this reason for denying subchapter S treatment for passive income has disappeared. Furthermore, elimination of the passive income limitation was included in the legislative proposals presented by the Treasury Department (both the 1968 and the 1969 recommendations) to simplify subchapter S and to deal with a series of other problems, such as the inadvertent terminations of elections.\textsuperscript{188}

The efficacy of the passive investment income limitation as a terminating event designed to ensure that only active businesses become S corporations is open to doubt. In \textit{Howell v. Commis-}


\textsuperscript{187} One fear has been that an individual receiving interest income could incorporate an S corporation to receive the income, convert all or part of the income into salary, and use the salary as the basis for his participation in a qualified deferred compensation plan. Under the Act, the typical S corporation that had never been a C corporation could never have accumulated any subchapter C earnings and profits and therefore would never need to concern itself with passive investment income.

sor, an S corporation was formed "to engage in a general investment business." The S corporation’s sole asset was an unimproved tract of land which it never subdivided, improved or advertised for sale. Holding that, under these facts, the S corporation enjoyed capital gain from the sale of what represented a capital asset purchased for investment rather than resale in the ordinary course of business, the court nevertheless rejected the Commissioner’s contention that the S corporation’s election should be terminated because it had no active trade or business. The court held that the sale of real estate was not included among the items of passive investment income as defined by Congress and therefore the corporation had not suffered the termination of its election. The Secretary acquiesced, later explaining that the passive investment income limitation "was intended as the sole test by which nonactive corporations were to be precluded from the subchapter S election."

The former passive investment income limitation not only proved ineffective at excluding from subchapter S those corporations with passive investment capital gains from the sale of real estate, but it also failed in certain instances to indicate precisely what kinds of income would fall within the prohibited class. A wide variety of facts has led to an equally wide variety of results. The most troublesome area has been rental income, where the Secretary has determined that the quantum of services provided by the lessor determines whether payments he receives are "rents." This leads courts into the arbitration of endless factual disputes concerning whether the degree of services supplied in a particular case has been sufficient to preclude stamping the rents received as passive investment income. Moreover, substantial tax consequences may turn upon whether an item is passive investment income. In a recent case, the taxpayer's use of an inaccurate method of accounting caused an increase in passive investment income,
which resulted in the retroactive loss of subchapter S election and a sizeable deficiency.\textsuperscript{197}

Summarizing that the passive investment income limitation caused much uncertainty, litigation, and retroactive terminations, the Staff Report recommended the abolishment of the passive investment income test.\textsuperscript{198} The Act, for many S corporations, effectively eliminates the passive investment income test and, for the remaining S corporations, greatly reduces its scope.\textsuperscript{199}

The fourth change in terminating events made by the Act is the elimination of the eighty percent limitation on non-U.S. source gross receipts.\textsuperscript{200} Although the legislative history does not explain the reason for originally including this test, the Staff Report sensibly notes that there is no reason to so discourage non-U.S. operations of an S corporation. The S corporation must be a domestic corporation and its shareholders must all be U.S. taxpayers, so all of their income will be subject to U.S. income tax.\textsuperscript{201}

In addition to making the four revisions to terminating events discussed above, the Act make two changes to prior law governing the effective date of a termination of a subchapter S election. One change is to the effective date of terminations by revocation and the other is to the effective date of terminations brought about by cessation of SBC status or by receiving excessive passive investment income for three consecutive years while having subchapter C earnings and profits for each of these years.

The Act increases the utility of termination by revocation while restricting the usefulness of termination by other means. Previously, a revocation operated prospectively only by taking effect in the taxable year following the taxable year in which made.\textsuperscript{202} The only exception to this rule was in the case of revocations during the first month of the taxable year, which always took effect as of the beginning of that year.\textsuperscript{203} Under the Act, a revocation may take effect retroactively to the beginning of the taxable year if made on

\textsuperscript{197} See \textit{Joseph Gann, Inc. v. Commissioner}, T.C. Memo 1982-104, 43 T.C.M. (CCH) 38,824(M). Use of the "first in-first out" method (FIFO) instead of average-cost accounting forced the S corporation's passive investment income to rise from 19.06\% to 20.87\% of gross receipts and resulted in deficiencies against shareholder of $302,163.74.

\textsuperscript{198} \textit{Subchapter S-Elections}, supra note 55, at B-705.

\textsuperscript{199} I.R.C. § 1362(d)(3)(A)(i) (1982). Note, however, the different requirements for the new excess net passive income tax to go into effect. See \textit{supra} note 4.

\textsuperscript{200} Former I.R.C. § 1372(e)(4) (1976) has no counterpart in the Act.

\textsuperscript{201} \textit{Subchapter S-Elections}, supra note 55, at B-705.

\textsuperscript{202} Former I.R.C. § 1372(e)(2) (1976).

\textsuperscript{203} Former I.R.C. § 1372(e)(2)(A) (1976).
or before the fifteenth day of the third month of the year. 204 If not made within that time, or if the shareholders do not seek retroactive effect, the revocation may take effect prospectively as of any date specified in the revocation, 205 and, if no date is so specified, the revocation will be effective on the first day of the following taxable year. 206

As to terminations caused by the loss of SBC status or excessive passive investment income, the Act has simultaneously removed both an unintended burden imposed upon unwary taxpayers and an unintended benefit available to sophisticated taxpayers, by eliminating the retroactive effect of these termination events. Previously, termination due to the loss of SBC status or excessive passive investment income related back to the first day of the taxable year in which the termination event occurred. 207 The results were equally dramatic for both the unwary taxpayer whose corporation unwittingly lost its subchapter S election and his more knowledgeable counterpart who intentionally caused the termination of the election. After the Act, these termination events cause the election to be terminated only as of the date that the event occurs. If the S corporation ceases to be an SBC, the termination is effective as of the date of the cessation. 208 If the S corporation has three consecutive years of excessive passive investment income, for each of which years it has subchapter C earnings and profits, the termination is effective on the first day of the first taxable year following the conclusion of the third year. 209

To ameliorate further the harshness of inadvertent terminations suffered by the unwary taxpayer, the Act authorizes the Secretary to continue to treat the corporation as an S corporation if steps are taken to reestablish it as an SBC within a reasonable time after discovery of the termination, and the corporation and each affected shareholder agrees to make the adjustments required by the Secretary. 210 The legislative history calls for a waiver of a terminating event "if the corporation timely corrects the event." 211 It states that excessive passive investment income can be "corrected"

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211. Senate Report, supra note 21, at 3264.
through the distribution, as dividends, of the accumulated earnings and profits during the subject three-year period. This solution may be unsatisfactory if there are excessive earnings and profits and the passive investment income exceeds the limit by a small amount. However, the Secretary has broad discretion to fashion a variety of remedies. The loss of SBC status naturally can be corrected, for example, by purchasing shares from a shareholder to reduce the number of shareholders to thirty-five or less or eliminate a corporate shareholder. Presumably, the Secretary again has sufficient flexibility to solve the allocation problems created by such a situation. The vagueness inherent in the statutory terms, "inadvertent," "reasonable" and "steps were taken" is intentional and leaves to the Secretary a broad discretionary power in granting waivers for inadvertent terminations. According to the Senate Report, the key prerequisite for the waiver will be that no tax avoidance has resulted.

Because the Act has created the possibility of the termination events or revocation or loss of SBC status taking effect in the middle of a taxable year, Congress had to provide for new accounting rules to accommodate the transition from an S corporation to a C corporation prior to the end of a taxable year. The Act provides that the taxable year in which the termination occurs shall be an "S termination year," consisting of an "S short year," which ends before the first day for which the termination is effective, and a "C short year," which is the remainder of the taxable year during which the termination became effective. Generally, the items to be taken into account for the S short year and the C short year are determined by computing for the S termination year the items of income, loss, deduction or credit that are separately stated under section 1366(a)(1)(A) and those items of income or loss that are not separately computed. Then the amount of each item is allocated on a pro rata basis through the entire taxable year. The S corporation may elect out of this procedure, however. If it does, and if all of the shareholders at anytime during the S termination

212. Id.
213. See supra text accompanying notes 52-69.
214. Senate Report, supra note 21, at 3264.
217. Id.
year consent to the election, the corporation may account for all of the items of income, loss, deduction and credit in accordance with its usual accounting procedures. Thus, in the case of an accrual basis corporation, the S short year items that will be passed through to the shareholders are those that arose prior to the effective date of the termination. Those items which arose at a later date are attributed to the new C corporation. The Act tries to minimize distortions due to the shortened year by projecting the taxable income of the new C corporation during the C short year for an entire year. It does this by multiplying the taxable income for the C short year by the number of days in the S termination year (usually 365) and dividing the product by the number of days in the C short year. This projected taxable income produces a tentative tax that is multiplied by a fraction whose numerator is the number of days in the C short year and whose denominator is the number of days in the entire S termination year.

Three miscellaneous rules also emerge from the Act's treatment of the S termination year. First, as to the C short year, the Act provides for a pro rata reduction of the $10,000 base for determining the new corporation minimum tax to reflect the abbreviated C short year. Second, the S short year is ignored for determining the number of carryback or carryforward years, so that the S termination year is counted as a single year for such purposes. Third, the corporate tax return for the S short year is due on the same date, including extensions, that the corporation tax return for the C short year is due. Finally, as to intentional terminations, the Act makes no change in existing law and provides that the corporation, or any successor, will not be eligible to make another subchapter S election before its fifth taxable year beginning after the first taxable year for which the termination was effective, unless the Secretary consents to an earlier election.

IV. Conclusion

The revisions contained in the Subchapter S Revision Act of

225. I.R.C. § 1362(g) (1976) is practically identical to former I.R.C. § 1372(f) (1982).
1982 regarding eligibility, elections and terminations will serve the twin purposes of the Act: to remove unintended burdens from unwary taxpayers and to preclude unintended benefits from sophisticated taxpayers. The new provisions liberalizing the definition of an SBC are helpful and should promote the underlying purpose of subchapter S: to reduce the tax considerations of choosing a form under which to organize the business or investment activities of a relatively small number of investors.

However, notwithstanding the many new similarities that the Act creates between S corporations and partnerships, it leaves untouched existing differences and even creates critical new distinctions between the two types of entities. Differences remaining between the tax treatment of partners and S corporation shareholders will continue to cause most taxpayers to prefer the partnership, especially for real estate investments, due to the avoidance of the at-risk rules and the greater flexibility in allocating income and deductions that the partnership offers.

The election provisions of the Act require that if the corporation elects to be taxed as an S corporation retroactively, the corporation must have been an SBC at all times during the retroactive period and all of its shareholders, during the same period, must consent to the election. Otherwise, allocation problems would arise when the benefits of subchapter S are extended to unqualified corporations or unconsenting shareholders.

The new termination events and provisions regarding their effective dates most clearly reflect the dual purposes of the Act. By eliminating the terminating events of affirmative refusal to consent, excessive foreign income and, in most cases, excessive passive investment income, and by eliminating retroactive terminations, the Act removes technical traps and devices that distorted the operation of subchapter S. By granting more flexibility to taxpayers

227. See supra notes 4, 7, 9, 10, 23 and 24.

228. Partners have greater flexibility than S corporation shareholders in allocating income, gains, losses, deductions and credits among themselves, provided the allocations do not have "substantial economic effect." I.R.C. § 704(b)(2) (1982). See generally McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 10.02 (1977) (discussing how to determine the validity of allocations under § 704(b) (1982). The S corporation has no similar flexibility due to requirements such as those prohibiting more than one class of stock, or prohibiting partnerships and most trusts from becoming shareholders. These requirements are designed to avoid the administrative difficulty of valuing shares and determining the proper allocations of income, losses and so forth. See supra text accompanying note 133. Also, the partnership generally does not realize gain upon the distribution of appreciated property to its partners.
in revoking elections and greater discretion to the Secretary in dealing with inadvertent terminations, the Act furthers the goal of ensuring the fair operation of the revocation and termination provisions. On balance, the eligibility, election and termination provisions of the Act successfully broaden the appeal of subchapter S to a wider range of taxpayers while, at the same time, reducing the opportunities to manipulate these provisions to produce impractical and often bizarre results of tax avoidance.