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Lorence L. Bravenec

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SUBCHAPTER S AS A VEHICLE IN REAL ESTATE
AND OIL & GAS

by

LORENCE L. BRAVENEC*

THIS ARTICLE DISCUSSES several significant problem areas faced in real estate
and oil & gas activities under the new rules for S corporations enacted
by the Subchapter S Revision Act of 1982 (hereinafter the "1982 Act"),1 as
modified by the Tax Reform Act of 1984 (hereinafter the "1984 Act").2

The 1982 Act brought the taxation of S corporations and shareholders
more in line with the partnership model, thus making the law conform more
to the expectations of the parties. At the same time, the 1982 Act removed
many of the serious pitfalls and the sought after planning devices under the
old law. Nevertheless, differences between S corporations and partnerships (or
proprietorships) remain, as does the necessity for planning in the use of S cor-
porations. Moreover, the law prior to the 1982 Act continues to be applicable
to certain oil and gas corporations so electing.3 The principal objective in making
such an election will be to continue use of the former rules relating to the in-
dependent producers and royalty owners exemption, which will view the S cor-
poration as a separate entity in applying the daily 1,000 barrel exemption.

I. CHOICE OF ENTITIES.

This article assumes that only three tax entities will be considered — the
partnership, the C or regular corporation, and the S corporation. Special en-
tities such as REITs (Real Estate Investment Trust) will not be discussed. In
making the choice of entities, the client initially must ask two basic questions:
Is passthrough treatment of overriding importance and is corporate status for
the enterprise of overriding importance?

If passthrough treatment is of overriding importance, the choice generally
is between an S corporation and a partnership. The differences between S cor-
porations and partnerships are surprisingly numerous. Some differences un-
doubtedly will be more significant than others. Thus, it will be quite material
whether, at the time the choice of entity is made, the business is incorporated
or not.

If the clients' business is presently unincorporated, the preference will prob-
ably be for organization as a partnership because of generally more favorable

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3Subchapter S Revision Act of 1982 at § 6(c)(3).
income tax rules. It is only when other factors intrude that the S corporation is the preferred choice. There are many differences between S corporations and partnerships to consider when starting with an unincorporated business. Several of these differences are discussed below.

**Special Allocations**

(1) **Partnership.** Special allocations of items of income, deduction, and credit are permissible under partnership rules if such allocations have substantial economic effect. ⁴

(2) **S Corporation.** The Subchapter S rules make no provisions for special allocations. The use of certain techniques, however, can achieve or approximate special allocations.

One technique for achieving special allocations utilizes a partnership of S corporations with each corporation representing different interests. For example, the promoter of a real estate venture and a group of investors would each invest in separate S corporations which would form a partnership. The partnership agreement would in turn provide for special allocations between two or more S corporation partners. How much complexity can the client tolerate?

This technique would seem to give full ability to achieve and not merely to approximate special allocations. ⁵ Achieving and not merely approximating special allocations could be quite crucial when proven oil and gas properties are transferred to an entity if full percentage depletion is to be preserved under the independent producers and royalty owners exemption. ⁶

The organizing of an oil and gas drilling venture as a carried arrangement in which the investors, the carrying parties, utilize an S corporation, can achieve a special allocation of the intangible drilling and development costs to the investors through the usual rules applicable to carried arrangements.

A second technique which will approximate special allocations is the use of stock options. A stock option is not recognized as an outstanding equity interest when the items of an S corporation are allocated, nor does it create problems with the prohibition against two classes of stock while unexercised. ⁷ Thus, stock options could be used in accomplishing special allocations by avoiding allocations to the holders of unexercised options. ⁸ However, the option

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⁴I.R.C. § 704(b).
⁶See I.R.C. § 613A(c)(9)(A), (10), and (13)(C); Prop. Reg. § 1.613A-7(n) and (o) (1977); and D. Massoglia and G. Choate, *Using an S Corp for Oil and Gas Operations: More Flexible But Still Restrictive*, 59 J. TAX’N. 102, 104-105 (1983).
⁸There could even be unexercised options to acquire stock as well as common stock.
price should not be a token amount, or the issuance of the option might be considered to be equivalent to the issuance of the optioned stock.9

For example, the promoter of an unincorporated venture could receive stock options, while the investors receive stock. The stock options could be exercisable within a reasonable period of time after the desired "flip flop". The investors will be taxed on net income of the corporation, receive any distributions, and have the benefit of net deductions.

Please note, however, that a stock option received for services will give rise to compensation income problems. The person performing services might prefer some arrangement in which there is no taxable compensation, or in which problems with taxable compensation are minimized. For example, an option which qualifies under section 422A will generally not give rise to taxable compensation.

Any compensation arising out of a nonqualified stock option is usually not deemed received while the option is outstanding, even if the option is substantially vested.10 Exercise of the nonqualified option is a taxable event if the stock acquired is substantially vested.11 However, the impact of taxes on the service provider from receipt of the stock option or stock compensation can be minimized or eliminated. If the corporation is able to deduct the compensation and does not have to capitalize it, the benefit of any deductions could be passed on to the service provider in the form of additional compensation by contractual agreement. For example, if all shareholders have an incremental rate of 50%, one dollar of stock option or stock compensation could be matched by one dollar of cash compensation. The service provider would have increased taxes and all shareholders would have decreased taxes by the amount of the one dollar cash compensation, which effectively neutralizes the options being treated as compensation.

Proposed Regulation §§ 1.83-6(e) & (f) and 1.83-7(c) would have permitted many option holders to accelerate the taxable event to the granting of the option, thereby minimizing the amount of the taxable compensation. However, these regulations were withdrawn in the summer of 1983.

Could a promoter avoid compensation by forming the corporation before seeking investors and by taking the option at a time when he or she is the only shareholder?

The income tax results for compensatory options probably are more favorable for corporations than for partnerships. For example, in case of a partnership, there is no provision comparable to section 422A providing for

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11I.R.C. § 83(a); Treas. Reg. § 1.83-1(a) (1978). See also infra text at 1, for the treatment of substantially nonvested stock.
qualified stock options. Further, according to one authority, the transfer of a partnership interest to the service partner as compensation for services is to be treated in part as a “transfer” to the service partner of undivided interests in individual partnership assets, accompanied by gain or loss recognition to the partnership on the undivided interests so “transferred”. A comparable gain recognition problem is not present in the case of S corporations.

Stock options would seem usable in tax shelters in which the promoter is to forego deductions during the period when there are net deductions, provided however, that the promoter’s services are deductible by the S corporation, that the promoter is given recognition by the other parties for increasing his compensation income, and that the parties have sufficiently high incremental rates.

Options would also seem usable in furthering estate planning objectives. For example, a parent makes a noncompensatory gift to a child of an option to purchase shares of stock, or a parent’s S corporation makes a compensatory grant of an option to the child in consideration for going to work for the corporation.

A third technique which will approximate special allocations, is the use of restricted stock as compensation for services. If stock received as compensation is forfeitable, i.e., substantially nonvested, the owner will probably be held to be a shareholder for Subchapter S purposes when the stock gives rise to compensation income. This taxable event occurs when the stock becomes substantially vested, unless the owner elects to treat the transfer of stock as a taxable event under section 83(b).

For example, assume that the investors receive seventy shares of vested stock and the promoter receives thirty shares of nonvested stock in an S corporation. Until the taxable event, when the promoter’s shares become vested if the section 83(b) election is not made, all items of income, deductions, and credit are allocated to the investors. While “dividends” to the promoter will be treated as compensation.

Thus, stock issued as compensation for services could play a role similar to that played by nonqualified stock options. It is assumed, however, that stock options would be preferable because they could be nonforfeitable without the security holder being considered to be a shareholder of the S corporation.

The author has his own theory about the status of restricted stock after the owner is considered to be a shareholder for Subchapter S purposes. Because restricted stock is subject to a buy-sell agreement, it arguably should be required that the repurchase price insure that the shareholder not be unfairly

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13Treas. Reg. §§ 1.83-3(a), (b), (c), and (d) (1978).
deprived of the undistributed net earnings on which he has been taxed. If there is a required sale and purchase, a formula price based on a reasonable multiple of earnings, or on book value, or a price based on appraised value should be sufficient. A right of first refusal based on an offer from a third person should also not create problems.\(^{14}\)

The income tax results for compensatory restricted property probably are more favorable for corporations than for partnerships.\(^{15}\) Please note that an agreement to issue stock for services, with the stock to be issued either as the services are performed or at a later date, which date could be the equivalent of a payout, probably will be governed by the rules for restricted stock and not the usual cash method deferral rules.\(^{16}\)

A fourth technique, which will approximate special allocations, is to enter into a compensation agreement with a person providing services to compensate him as if he owned a given number of shares of stock referred to as “phantom shares”. When dividends are paid on outstanding shares, the person providing services would be paid compensation as if he received dividends on the phantom shares. When the time came to cash in his interest, he would be paid a sum as if the phantom shares were sold. Because the service provider realizes only ordinary income and not capital gain, it might be necessary to pay additional compensation.\(^{17}\)

The holding of the *Parker Oil*\(^8\) case may offer a fifth technique which will approximate special allocations. *Parker Oil* involved the status of a shareholder voting agreement under the former, one class of stock requirement,\(^{19}\) which, among other things, prohibited different voting rights among shareholders.\(^{20}\) The case held that such an agreement was permissible since there was no creation of a second class of stock because of voting right differences imposed by state law or in the corporate charter.\(^{21}\) Differences in voting rights imposed by a shareholder agreement did not create a second class of stock.\(^{22}\)

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\(^{15}\)See supra text at 1.


\(^{17}\)See supra text at 1.


\(^{21}\)58 T.C. at 991.

\(^{22}\)58 T.C. at 990. The Court also stated that their views of Congressional intent was shared by other courts and cited *A. & N. Furniture & Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967), and *Portage Plastics Co., Inc. v. United States*, 301 F. Supp. 684 (W.D. Wis. 1969) *rev'd on other grounds* 470 F.2d 308 (7th Cir. 1972).
In the process of deciding the *Parker Oil* case, the Tax Court held Treasury Regulation § 1.1371-1(g) and Revenue Ruling 63-226 invalid to the extent that they provided that a second class of stock was created by this type of transaction, where not all of the outstanding shares of stock had identical voting rights because of a shareholder agreement.

Using the holding of *Parker Oil*, it could be argued that it is permissible for parties to enter into a contractual arrangement where one party would be entitled to all or part of another’s dividends and/or distributions upon liquidation. Such a contractual arrangement in effect splits the ownership rights in those shares, and the parties must share with the other person the dividends or assets upon liquidation.

Under such an arrangement, one person will get the benefit of Subchapter S corporation earnings taxed to another. In effect, one person will receive dividends and/or distributions upon liquidation, attributable to the shares of stock, while the other party (the shareholder) will be allocated items of income, deduction, and credit relating to those shares.

In Subchapter S corporations where some or all of the shareholders are related, there are particular problems. When shareholders have waived dividends, thereby benefiting another family member, the court has found these transactions to be gifts and considered them as constructively received by the waiving party for tax purposes. It appears that the only possible way around this type of holding might be if the waiver was executed for a legitimate business purpose.

A sixth technique for approximating special allocations is to use “straight debt”. While an S corporation cannot have a second class of stock, there is a straight debt safe harbor for an instrument which may be either true debt or equity. To qualify for the safe harbor, among other things, the debt must not be convertible, must not provide for interest contingent on profits, and must provide for the payment of a fixed sum of money. Straight debt can in effect function as an equity interest which has a different share of profits and assets.

For example, a lead tenant and a developer form a venture to hold a shopping center through an S corporation, and the lead tenant is to receive 30% of the profits and losses while contributing only 5% of the capital. By struc-
turing a portion of the developer's commitment to the venture as a straight
debt, his interest in stock could be limited to 70%. Thus, the lead tenant could
be issued 30% of the S corporation stock.

As another example, a parent and a child form an S corporation, each
investing $10,000 for a 50% interest in the stock of the corporation. The parent
also loans the corporation $100,000 for fifteen years at ten percent interest,
which qualifies as straight debt. Under this example, the child has 50% of the
future growth of the corporation for a relatively small investment. The
parent has, in part, an investment in the "debt" which is roughly comparable
to preferred stock.

As a third example, an S corporation is formed by X, who invests $100,000
for 1,000 shares of stock. Y loans to the corporation $100,000 for three years
at 10% interest. Y is also given an option to purchase 1,000 shares for $100,000,
exercisable at the end of the three-year period. It is not clear whether or not
in substance Y has taken convertible debt, Y is payable other than a sum cer-
tain in money, or the interest rate or payment dates are contingent on profits,
thus casting considerable doubt on the availability of the straight debt safe
harbor.

The use of straight debt, while simple in operation, does not produce fine
tuned special allocations. Please note that, although it is not required that the
rate of interest be reasonable for the debt to qualify for the safe harbor, ad-
justments may be made within a family if capital is furnished without reasonable
compensation. 29

Termination of an Interest.

The share of each shareholder in the corporation's items of income, deduc-
tion, and credit generally is determined by allocation based on ownership of
stock on each day of the corporation's full taxable year. This is referred to
as the full day allocation method. 30 As an example, a calendar year S corpo-
ration has two shareholders, A with ninety-eight shares and B with two shares.
On June 15, 1983 (the 165th day of 1983), C purchased B's two shares and
ninety-six shares from the corporation, thereby making A and C each the owner
of 50% of the stock. For the year 1985, the corporation had operating profits
of $36,500, of which $30,000 was earned in the first 165 days and $6,500 in
the last 200. Under the per day allocation method, $16,500 would be allocated
to the first 165 days (of which $16,170 would be allocated to A's 98% and
$330 to B's 2%) and $20,000 would be allocated to the last 200 days (of which
$10,000 would be allocated to A's 50% and $10,000 to C's 50%).

An alternative method is potentially available in determining each
shareholder's share of the corporation's items of income, deduction, and credit,

29I.R.C. § 1366(e).
30I.R.C. § 1377(a)(1).
in lieu of the per day allocation method. If there is a termination of interest of a shareholder, then all affected persons may elect to terminate the taxable year as of the date of termination of the interest. This is called the “interim closing of books” method. For example, consider the same facts as used above. Because B’s interest has terminated, the parties may elect the interim closing of books method. Under this method, $30,000 will be allocated to the first 165 days (of which $29,400 would be allocated to A’s 98% and $600 to B’s 2%) and $6,500 would be allocated to the last 200 days (of which $3,250 would be allocated to A’s 50% and $3,250 to C’s 50%). A’s and B’s shares of income have increased by $6,750, $6,480 and $270 respectively, under the interim closing of books method, while C’s share has decreased by a like amount.

The interim closing of books method may be useful when there is a shifting of stock ownership, such as through redemption of shares, issuance of new shares, or sale of previously issued shares.

An S corporation should have at least one shareholder whose interest can be terminated in those situations in which the interest of one or more shareholders is reduced but not terminated. For example, when stock is issued to a new shareholder, the parties might wish to use the interim closing of books method instead of the full year allocation method.

A legitimate provision for a shareholders’ agreement would be to specify the conditions under which the shareholders are to agree to the interim closing of books method.

Flip Flop in a Shelter.

Many shelters are designed so that substantially all of the items of income, deduction, and credit will be allocated to cash investors until “payout”. After “payout”, the promoter is given a larger percentage interest, and the interests of the cash investors are diminished.

(1) Partnership. The decreasing of the investors’ interests in profits and losses gives rise to shifting in shares of liabilities under section 752, to an imputed distribution of cash to the investors under sections 752 and 731, to a shifting of interests in any section 751 assets, and to investor gain potentially taxed as ordinary income under section 751.

(2) S Corporation. The shifting of interests in an S corporation is not treated as a distribution giving rise to ordinary income to those whose interests are diminished.

Collapsibility.

The basic differences between the rules for collapsible corporations (principally found in section 341), applicable to the shareholders of S corporations,
and for collapsible partnerships (principally found in section 751) are well known.

Several changes in the Subchapter S rules, however, affect the applicability of section 341 and make Subchapter S more usable. One such Subchapter S change was the increasing of the maximum number of permitted shareholders to 35. Since the section 341(d)(1) collapsible corporation rules do not apply to a shareholder who does not own more than 5% in value of the stock at any time after the commencement of the manufacturing, construction, or production or the corporation’s property, or after the purchase of the property, it will be relatively easy to have S corporations with a large number of shareholders in which no one shareholder owns more than 5% in value of the stock. These shareholders thus will not be deprived of long term capital gain on the disposition of their stock or on a distribution by the corporation.

The following examples help to illuminate this concept.

Example. An S corporation is organized on October 3, 1983, with 25 shareholders each contributing $8,000 for a total of $200,000 for the corporation’s stock. Shortly thereafter, the corporation drills a producing oil well and incurs intangible drilling costs of $200,000. The S election terminates on February 28, 1984. On October 4, 1984, the investors sell their stock for $500,000; each receiving $20,000. The investors have $200,000 of deductions in 1983 and $500,000 of long term capital gain in 1984. If the investors had not terminated the S election or had used a partnership instead of an S corporation, the 1984 gain would have been $200,000 of ordinary income and $300,000 of long term capital gain. It is not clear whether section 1254(b)(2), which is expressly applicable only to S corporations, may be avoided by the deliberate termination of an S election in anticipation of the sale of the corporation stock.

Example. An S corporation is organized on October 3, 1983, with 25 shareholders each contributing $8,000 for a total of $200,000 for the corporation’s stock. Shortly thereafter, the corporation purchased depreciable real estate for $600,000, giving a purchase money mortgage for $400,000. After two years of operation, the net deductions passthrough for each shareholder totals $7,240. The stock is sold by all shareholders for a price of $10,000 per shareholder. Each shareholder has a long term capital gain of $9,240. If the venture had been organized as a partnership, part of the gain would have been ordinary income under the recapture rules of sections 1245 and/or 1250.

Example. A group of 25 investors organized an S corporation and contributed $2,000 each for its stock, a total of $50,000. The corporation purchases rental real estate for $250,000 on January 1, 1984, giving $50,000 cash and its note for $200,000, secured by a mortgage on the realty. It uses the cash method and a fifteen year life for the depreciable part of the realty and takes

92 I.R.C. § 751(c) (partnerships) and § 1254(b)(2) (S corporations).
$27,000 depreciation for 1984 and $22,500 for 1985. Its cash income equals its cash expenses each of the years. It terminates the S election on December 31, 1985. On January 1, 1986, it sells the realty for $250,000, and liquidates, distributing the proceeds net of taxes and net of principal owing on the note to its shareholders. Assuming a shareholder incremental rate of 50% and the regular C corporation rate structure for C years, the shareholders would save a total of $24,750 on the total net deductions for 1984 and 1985. The 1986 sale and liquidation would produce a corporate level tax of $8,160 and shareholder level tax of $9,900, for a total of $18,060. If the S election had not terminated, or if the parties had used a partnership, the results would have been the same except that the 1986 tax at the owner level would have been $24,750 and not $18,060, producing a savings of $6,690 from use of the S corporation to passthrough losses and from use of the C corporation to trap the ordinary income. If the investments are twice as large, there would be no such savings, largely because the corporate rates increase substantially on taxable income above $50,000. The favorable result indicated by the example turns in part on the fact that there need not be a business purpose for terminating the S election, that the corporate rates are relatively low on the first $50,000, and that any double taxation is minimized because of the shareholder 60% long term capital gains deduction.

Another change was the forced recognition of gain on distribution of appreciated property to shareholders. The amount of gain recognized will increase the shareholders' bases in their stock and make it less likely that a distribution of appreciated property will create gain subject to taxation of ordinary income under section 341.

**Burnout.**

S corporations have a significant potential advantage over partnerships after the burnout of a tax shelter when an investor gives his interest in the venture to another person. On the burnout of a partnership shelter, each owner's basis in the partnership is likely to be significantly less than his share of partnership liabilities, and the partnership is likely to have significant section 751 ordinary gain potential. Thus, a gift of the partnership interest will trigger significant ordinary income to the donor-partner. On the other hand, when an S corporation is used, the gift of the corporation's stock will not give rise to any gain recognition. However, if the former shareholder has retained any corporation notes, the basis of which have been reduced because of net deductions passthrough, he will recognize capital gain on his repayment. Nevertheless, the tax on the donor-shareholder's capital gain, plus the tax to the donee-shareholder(s) on net income from the eventual disposition of the shelter property, could be substantially less than the tax on the gift of the partnership.

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[I.R.C. § 1363(d).]

interest, if the donees have a low incremental tax rate. Moreover, the income recognition relating to use of the S corporation will occur after the gift and not at the time of the gift, as in the case of a partnership.

Different Distribution Rights.

(1) Partnership. There is no express prohibition against different distribution rights of partners. As a consequence, partnerships are quite flexible for distribution rights involving unrelated parties and for estate plans involving estate “freezes”.

(2) S Corporation. In contrast, under Subchapter S, the requirement of only one class of stock prohibits outstanding stock with different interests in dividends and in assets upon liquidation. However, the special allocation techniques have potential for different distribution rights.\textsuperscript{36}

Outside Basis and Inside Debt.

Both partners and S shareholders are subject to a basis limitation on the passthrough of net deductions. Net deductions in excess of the basis limitation are carried forward and are potentially usable in subsequent years. There are two important differences, however, in computing the basis limitation of partners and S shareholders.

(1) Partnership. Each partner looks to the basis of his partnership interest, which does not necessarily include the full amount of his loans to the partnership. However, each partner’s basis in his partnership interest includes the partner’s shares of debt for which there is recourse against his assets including the partner’s loans to the partnership. Each partner’s basis also includes the partner’s share of partnership nonrecourse debt.\textsuperscript{37}

(2) S Corporation. In contrast, each shareholder looks to the basis of his stock and of debt due to him by the corporation.\textsuperscript{38} However, he does not have a basis in any other debt owed by the corporation, even if there is recourse against him (e.g., as a guarantor), until he pays, or becomes primarily liable for, the debt and becomes subrogated to the creditor’s rights against the corporation.

Examples. An entity having two equal owners, $A$ and $B$, borrows the following amounts, producing the indicated basis to the owners depending upon whether the entity is a partnership or an S corporation:

\textsuperscript{36}See supra text at I.
\textsuperscript{37}I.R.C. §§ 721 and 752.
\textsuperscript{38}I.R.C. § 1366(d)(1).
### Loans

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<th>Partnership</th>
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<td></td>
<td>A</td>
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<tr>
<td>$10,000 from B, nonrecourse</td>
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<tr>
<td>$10,000 from C, full recourse</td>
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<td>$10,000 from D, recourse only against A</td>
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<tr>
<td>$10,000 from E, nonrecourse</td>
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The results for the owner loans probably are more satisfactory for S corporations than for partnerships, in that, as the example demonstrates, the creditor gets full basis from the loan. However, if the results are not deemed satisfactory for S corporations, it would seem to be relatively easy for one shareholder to loan the other part of the money, followed by a loan by both to the corporation. Further, if the results are not deemed satisfactory for a partnership by the partner furnishing funds, it would seem relatively easy to get different tax results with comparable rights to distributions by the partner making a capital contribution, instead of a loan. The partnership agreement can give this contribution preferential distribution rights over other equity and can also provide a guaranteed payment or charge for the use of money.

The results for the third party recourse loans probably are more satisfactory for partnerships than for S corporations. However, the shareholder or shareholders could get basis by converting the third party loan into a direct shareholder loan. Using the above example, shareholder A could become primarily liable to D for $10,000 and the corporation could become directly liable to A. Alternatively, A could pay D $10,000 and become subrogated to D's rights in the loan.

Similarly, the results for the third party nonrecourse loans probably are more satisfactory for the partnership than for the S corporation. However, the shareholder or shareholders could get basis in many cases without real exposure. For example, assume that the $10,000 nonrecourse loan from E in the above example is made to acquire, and is secured by a lien on real estate costing $11,000. An equivalent arrangement from E's point of view would be for E to make a $3,000 recourse loan to A and B, for A and B to loan $3,000 to the corporation secured by a first lien on the real estate, and for E to make a $7,000 nonrecourse loan to the corporation secured only by a second lien on the real estate. However, under this modified arrangement, A and B would each get basis of $1,500 and would have limited exposure because their loan is secured by the first lien.

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Repayment of a third party loan in installments could give rise to gain to the shareholders of an S corporation under circumstances when it would not give rise to gain to the partners of a partnership. For example, assume that a third party loan is payable in installments over a ten year period and that there are net deductions for the first five years and net income for the remaining five years. Installment repayment of the loan by a partnership need not give rise to gain to the parties, as long as each partner’s basis in his partnership interest is always equal to his share of the reduction of partnership debt. In the case of an S corporation, however, the third party loan is likely to have been made to the shareholders who in turn loaned the funds to the corporation. Each shareholder is likely to depend on the corporation to furnish the funds for the discharge of his liability to the third party. If a shareholder’s basis in the corporation’s debt to him has been reduced through the net deductions passthrough, the payment of an installment to him will give rise to recognition of gain according to the following formula: Payment x (Face Amount of Debt - Shareholder’s Basis in Debt) / Face Amount of Debt. The foregoing problem of the S corporation’s shareholders could easily be solved by their contributing, as equity capital, the funds borrowed from the third parties, or by their loaning the funds using balloon notes, instead of using an installment payment arrangement.

Perhaps the most sought after corporate attribute is limited liability. While insurance will protect partners, the partnership, shareholders and the corporation against many forms of liabilities, there will be situations in which insurance will not be deemed adequate. Further, while limited partners are given limited liability, they thereby lose their ability to participate in the management and control of the enterprise.

**Starting with an Incorporated Business**

If the client’s business is presently operating as a C corporation, the preference for passthrough treatment will probably be for the S election in order to avoid the liquidation necessary to operate as a partnership. However, factors other than the tax cost of a liquidation should be considered.

I. Liquidation.

(a) **Partnership — Section 331.** One form of liquidation is under section 331, in which each shareholder’s entire realized gain is included in income, generally as capital gain unless the collapsible corporation provision is applicable or the shareholder’s stock is dealer stock. Moreover, the corporation would increase its taxes because of the recapture provisions such as sections 1245 and 1250. While the section 331 liquidation exacts a tax price, the continuing business

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*See supra text at I.*

*For an in-depth discussion, see infra text at IV.*
Section 333. Another form of liquidation is under the elective section 333, in which the shareholder’s realized gain is included in income only to the extent of his share of the greater AE&P (Accumulated Earnings and Profits) as determined under the accrual method, or stock and securities acquired after 1953. This included gain, if any, is taxed as ordinary income to the extent of the shareholder’s share of AE&P and the balance of the included gain, if any, is capital gain. Section 333 is not available if the collapsible corporation provision is applicable. Section 333 normally is not advantageous unless AE&P is insubstantial.

Partnership of the C Corporation and its Shareholders. An alternative which avoids liquidation is for the shareholders to enter into a partnership with the corporation for the operation of one or more of the corporation’s businesses. This arrangement may be illustrated as follows:

This approach is relatively untested, and may require the presence of a substantial business purpose and substantial contribution of property or services for the partnership to be recognized. The approach would appear to be usable if corporation losses are anticipated, if necessary funds can be obtained only from shareholders, and if Subchapter S is not otherwise available or appropriate. As to the last condition, Subchapter S might not otherwise be appropriate if only part of the shareholders are willing to participate in advancing funds to the business and if special allocation and distribution provisions, not possible under Subchapter S, are necessary.

(b) *S Corporation.* The making of the S election does not of itself give rise to a deemed liquidation under section 331 or section 333, nor to any recognized gain. Moreover, the corporation’s inside asset bases do not change with the making of the election and are used to compute the corporation’s items of deduction and of gain and loss which pass through to its shareholders. This result is particularly advantageous because the corporation’s inside asset bases could have been increased through retention of C corporation earnings which have never been taxed to the shareholders.

**Example.** A shareholder has a basis of $350,000 in stock of a C corporation with cash of $150,000 and depreciable property worth $550,000 and no liabilities. The basis to the corporation of its depreciable property is $400,000 with an assumed depreciation recapture potential of $100,000, and the corporation has AE&P of $200,000. We will assume a corporate rate of 50% and an individual rate of 50% on ordinary income and 20% on long term capital gain in evaluating the different alternatives:

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Shareholder</th>
<th>Total</th>
<th>Basis of Depreciable Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/S — 331</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidation</td>
<td>$50,000&lt;sup&gt;a&lt;/sup&gt;</td>
<td>$300,000</td>
<td>LTCG&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>P/S — 333</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidation</td>
<td>50,000&lt;sup&gt;a&lt;/sup&gt;</td>
<td>250,000</td>
<td>OI&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>S Corporation</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>P/S — 331</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidation</td>
<td>0&lt;sup&gt;a&lt;/sup&gt;</td>
<td>100,000</td>
<td>OI&lt;sup&gt;f&lt;/sup&gt;</td>
</tr>
<tr>
<td>of S Corporation</td>
<td></td>
<td>250,000</td>
<td>LTCG</td>
</tr>
</tbody>
</table>

Notes:

a. Under a section 331 or a section 333 liquidation, the corporation will have to recognize depreciation recapture of $100,000 and pay a tax of $50,000, unless the S election is made prior to liquidation.

b. The shareholder’s gain is the difference between the amount realized of $650,000 (cash of $100,000 and depreciable property of $550,000) and stock basis of $350,000.

c. Under section 333, the shareholder would have to recognize ordinary income in the amount of AE&P ($200,000 pre-existing and $50,000 arising out of the liquidation), limited to realized gain.

d. $350,000 (original basis in stock) + $250,000 (gain on liquidation) − $100,000 (cash after corporate taxes).
e. The S corporation would have the same basis for the assets as the C corporation.

f. The depreciation recapture of $100,000 would be recognized at the corporate level and passed through to the shareholder. He would have a basis increased to $450,000, reducing his gain to $250,000.

Under the facts, the S corporation alternative is the preferred one, because the shareholder gets the benefit of the corporation's inside basis of $550,000 ($150,000 cash + $400,000 other assets) without incurring any tax liability. While the "P/S — 331 liquidation of S corporation" gives an increased asset basis of $700,000 ($150,000 cash + $550,000 other assets), for an increase of $150,000, this increase is available only by incurring a tax liability of 66 2/3 % or $100,000.

Other Partnership and S Corporation Differences.

The previous discussion entitled "Starting with an Unincorporated Business" is largely applicable to the present context.

Special Problems of Prior C Corporations. The S corporation with a prior C history, however, faces a wide range of special rules, which are generally unfavorable, in addition to those faced by S corporations without prior C history. These special rules include possible termination of the S election because of excessive passive investment income (EPII), the special section 1375 tax on EPII, the special section 1374 tax on long term capital gains, the applicability of Section 219 for the first three years of the election, and shareholder taxation on AE&P. On the other hand, a partnership acquiring a liquidated C corporation's business does not face any of these special rules. These special rules are discussed later.

Percentage Depletion. The availability of the independent producer and royalty owners exemption will be lost for proven properties, whether the corporation's C status is terminated by liquidation or by making the S election. Further, the shift back to C corporation status on termination of an S election is governed by the same set of rules as the incorporation of a partnership.

II. CORPORATE STATUS DESIRED.

If corporate status for the enterprise is of overriding concern, then the choice generally is between an S corporation and a C corporation. The basic difference between the two entities is that passthrough treatment is applicable to S corporations, while the C corporation is an entirely separate tax entity.

Many corporations plan to move from C to S to C status. Such changes

"See supra text at I.
"I.R.C. § 613A(c)(10) and (13)(D).
of status, if voluntary, are generally done without tax cost because the making of the S election by a C corporation is not treated as a liquidation of the C corporation, and the termination of the S election is not treated as the incorporation of a business.\footnote{There are special rules for proven oil and gas properties. See infra text at II.} Moreover, the S election may be on a short term basis. That is, there is no required minimum number of years for the election. However, if the S election is terminated, it generally cannot be made again for five years.\footnote{I.R.C. § 1362(g).} Also, there is a potential corporate level tax on the S corporation for capital gains realized in the first three years of the S election if there is prior C corporation history. In addition, the AAA account of a terminated S election period does not carry over to a later S election period.

The net deductions passthrough to the shareholders is one of the principal reasons for making the S election. Whether the election is made when corporation losses are anticipated ultimately turns on the prediction that the corporation or the shareholders will derive greater net tax benefit from the corporation's net deductions. At a minimum, the following factors should be considered:

**Current Benefit.** Will the corporation be able to offset its projected net deductions against prior years income? Or, must the corporation carry all or part of the deductions forward to offset future income, if any? Will the shareholders be able to meet the adjusted basis limitation? If so, will the shareholders be able to offset the projected net deductions in the current year and in prior years as a carryback? Or, must they carry all or part of the deductions forward to offset future shareholder income, if any?

**Tax Rate.** What is the incremental tax rate on the corporation's income which the projected net deductions will offset? What is the incremental tax rate on the shareholder's income?

**Other Items.** What will be the effect of the net deductions on such corporate items as prior and subsequent investment credits and on prior and subsequent capital gains and the alternative tax thereon? What will be the effect of the net deductions on such shareholder items as the investment credit and on nonbusiness deductions of shareholders under section 172(d)?

C corporation treatment is usually desired when a business is profitable and is in a growth position or is repaying substantial debt. The C corporation is particularly useful with smaller, closely held enterprises in shifting income from the owners, where it might otherwise be taxed at rates as high as 50% to the C corporation, where it is taxed under a separate rate schedule which begins at 15%.

However, if the incremental C corporate rate would otherwise be 46%,
perhaps because the corporation is part of a controlled group subject to section 1561, the passthrough treatment of Subchapter S becomes a more desirable alternative. In the latter case, although the highest applicable shareholder rate (50%) under passthrough treatment is 4% greater than the highest C corporation rate (46%), avoidance of double taxation problems seems worth this extra 4%.

A. The Mature Business.

If substantial distributions of current income are contemplated by a business, either because of special shareholder needs or because of a potential accumulated earnings tax, then the S election is particularly useful in avoiding a substantial double tax under the C corporation alternative.

Distributions Out of AE&P. However, the S election would not be particularly useful if substantial distributions are to be made out of AE&P, because there would be a shareholder tax on such earnings as well as the prior corporate tax.

Accumulated Earnings Tax (AET). Subchapter S would be particularly useful if there are potential problems with the AET. Not only is the AET inapplicable during the period of an S election, but the S election has several special uses.

Revenue Ruling 72-152, 1972-1 C.B. 272, conceded that a cash dividend made on or before the fifteenth day of the first year of the S election would qualify in computing the AET under sections 535(a), 561, and 561(a), for reduction of accumulated taxable income of the last C year. While Revenue Ruling 72-152 involved a cash dividend, there is no reason why it would not apply to a distribution of noncash property.

Subchapter S might be used to strip the corporation of excessive investments in stock, securities, and other pure section 1221 capital assets which are causing potential problems under the AET. Care must be taken, however, that the amount of any distribution during a taxable year does not exceed the corporation’s AAA (Accumulated Adjustments Account). While a distribution of appreciated investments will be treated as if the corporation sold the property to its shareholders, this is not ordinarily a problem, because the gain will be capital gain (section 1239 applying only to depreciable property) which will increase the S corporation’s AAA and thus the amount of the distribution that can be made before being taxed as ordinary income out of AE&P. However, the corporation’s capital gain would be potentially subject to the special section 1374 corporate level tax.

Personal Holding Company Tax (PHC tax). The S election would not be especially helpful to corporations potentially subject to the PHC tax if the special section 1375 corporate level tax on the (EPII) of S corporations is applicable.
The S election would not be helpful to a holding corporation which derives its income principally from dividends, because such a company is entitled to an 85% dividends received deduction in computing its taxable income (although not its undistributed PHC income for the PHC tax) and usually distributes all net income currently to its shareholders, thereby substantially avoiding double taxation. Similarly, the S election would not be useful if the corporation's income were principally from real estate rents, because such a corporation need distribute only minimal amounts under section 543(a)(2)(B) and thus does not have a substantial double taxation problem.

If the corporation has substantial interest income as its principal source of income, the S election could be useful even though there would be a corporate level tax on EP II. For example, assuming a shareholder rate of 50%, if the corporation has only interest income of $200,000 and not expenses, the sum of the C corporation tax ($71,750) and the PHC tax (if net earnings are not distributed or the shareholder tax if net earnings are distributed, $64,125) would be $135,875 for the C alternative. However, under the S election, the sum of the section 1375 tax ($69,000) and shareholder tax ($65,500) would be $134,500, producing a saving of $1,375. The breakeven point, using similar assumptions, would be approximately $176,000. Of course, any use of the S election would necessarily be short term, because the election would terminate after three years of EPII.

If the corporation has substantial oil and gas royalties and is able to avoid the PHC tax under section 543(a)(3) by reason of the royalties not being PHC income, then the S election probably would not be useful. If such a corporation is not able to avoid the PHC tax as a C corporation, however, the S election might be useful in limited situations.

If the corporation is able to manage its gross receipts, income, and deductions so that the section 1375 tax is nominal or is avoided, the S election would generally be a good alternative to C corporation status.

B. Special Situations.

Switch to Partnership. If liquidation of a C corporation is contemplated in order to operate the business in unincorporated form, the making of the S election prior to liquidation will avoid taxation of the corporation on its ordinary income recapture (such as depreciation recapture).**

Sale of Operating or Investment Assets. If operating or investment assets of the corporation are to be sold and the proceeds distributed to the shareholders, the S election would be useful in minimizing or avoiding any corporate tax. The only corporate tax would be imposed under section 1374 and under the minimum tax, and the overall tax liabilities on the corporation and its shareholders might be less under the S alternative than under the C alternative.

**See examples given supra, text at I.
**Tax Exempt Interest.** Subchapter S would not be a desirable alternative for a corporation having exempt interest as the principal source of income. In the first place, such interest does not increase AAA. Thus, any payment of dividends, even if traceable to funds from tax exempt interest, could be ordinary income out of AE&P. Secondly, tax exempt interest is a form of passive income which could be taxed under the tax on excessive passive investment income if there were taxable income.\(^9\) For example, if an S corporation had gross receipts of $100,000, tax exempt interest of $50,000, a long-term capital gain of $25,000, and no other income or deduction, it would be subject to a section 1375 tax of $11,500.

If proven oil and gas properties are transferred to a corporation and it is desired to retain percentage depletion under the independent producers and royalty owners exemption, different rules apply to a transfer to an S corporation under section 613A(c)(13)(C) than to a transfer to a C corporation under section 613(c)(10).

**Special Problems of S Corporations with a Prior C History.** The S corporation with a prior C history faces a wide range of special rules, generally unfavorable. These special rules are listed under II above.

**III. DISTRIBUTIONS.**

**A. Corporations Without AE&P.**

If a distribution to a shareholder is made by an S corporation with no AE&P, the amount of the distribution first reduces his stock basis and is nontaxable to the extent of such basis.\(^51\) The excess above stock basis, if any, is treated as gain from the sale or exchange of property, unless the collapsible corporation provision applies. It is important to note that an S corporation generally has no adjustments to E&P during the period of the election covered by the new rules which is generally for taxable years beginning after 12/31/82.\(^52\) Corporations without AE&P will need to keep a record of the AAA if their shareholders are to take advantage of the special rule for cash distributions out of AAA during the post-termination transition periods.\(^53\)

**B. Corporations with AE&P.**

Many S corporations will have AE&P, either prior to making the S election during Subchapter S years prior to the effective date of the 1982 Act, and/or following acquisition of a corporation with AE&P. Such corporations however, will make no adjustments to E&P during the period of the election covered by the new rules, except for dividends out of AE&P and the extraordinary cor-

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\(^9\)See infra text as IV, F.

\(^51\)I.R.C. § 1368(b).

\(^52\)I.R.C. § 1371(c).

\(^53\)See infra text at III, B.
poration transactions such as redemptions, liquidations, acquisitions, and division.  

The relationship of the prohibition against adjustments to AE&P during the S years and the cost recovery rules of section 168 and 312(k) is not clear. Section 312(k) provides for computing E&P as if intermediate life, straight line cost recovery under section 168 is used, regardless of the method used in computing taxable income. For example, if three year property is placed in service and a three year recovery is used, E&P must nevertheless be computed using a five year life.

Example. In 1983, a corporation acquires 3-year property for $10,000 and uses a 3-year recovery period in computing taxable income. Its taxable income for each of the years involved is zero.

C Status for All Years. If the corporation were a C corporation for all years, it would compute its taxable income and E&P as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Income</th>
<th>Earnings &amp; Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$2,500</td>
<td>$(2,500)</td>
</tr>
<tr>
<td>1984</td>
<td>3,800</td>
<td>(3,800)</td>
</tr>
<tr>
<td>1985</td>
<td>3,700</td>
<td>(3,700)</td>
</tr>
<tr>
<td>1986</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1987</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Please note the catch-up effect in AE&P in the last two years.

S Status for All Years. If the corporation was an S corporation for all years, it would have no adjustments to E&P.

C Status to S Status. If the corporation has C status for 1983 through 1985 and S status for 1986 and 1987, it has AE&P of $4,444 at the beginning of 1986. There is no catch-up in 1986 and 1987 or in any other year.

S Status to C Status. If the corporation has S status for 1983 through 1985 and C status for 1986 and 1987, it has no AE&P as of the beginning of 1986. The literal language of section 312(k) nevertheless requires that it reduce E&P by $2,222 in each of the years 1986 and 1987. Is this too good to be true?

New Section 312(n). Section 312(n), enacted by the 1984 Act, creates

41 I.R.C. § 1371(c).
numerous situations in which timing of income and deduction items is different in computing E&P and taxable income, thus giving rise to problems similar to those discussed under "A" above.

First Out of AAA; Election to By-Pass AAA. The amount of any distribution will be considered to be first as a return of capital to the extent of the S Corporation’s AAA. To this extent, the distribution reduces the shareholder’s stock basis and is nontaxable, and the excess, if any, above stock basis is treated as gain from the sale or exchange of property, unless the collapsible corporation provision applies. However, if all affected shareholders elect, AAA will be by-passed as a source of distributions. The election to by-pass AAA could be useful if it were desired to avoid rules triggered by the presence of AE&P such as those relating to excess passive investment income. Further, if it is relatively certain, but not entirely, that there is not AE&P, the election should have no tax cost to shareholders and at the same time should give assurance that future years will not be burdened with AE&P.

AE&P; Other Return of Capital. Distributions in excess of AAA are taxed as dividends to the extent of AE&P. The amount of the distributions in excess of AAA and AE&P is treated as a return of capital. Such a return of capital distribution is nontaxable to the extent of remaining stock basis and reduces stock basis, and the excess, if any, above stock basis is treated as gain from the sale or exchange of property, unless the collapsible corporation provision applies.

AAA Defined. AAA is a corporate level account, and not a shareholder account as under former law. In general, the account is adjusted by the same amounts which are taken as adjustments to basis. It is increased by corporate income items but not tax exempt income, decreased by the corporation’s items of deduction but not deductions relating to tax exempt income, decreased by distributions out of AAA, and decreased by a pro rata part of AAA in the event of a stock redemption treated as an exchange. Distributions during a taxable year may be out of the entire amount of AAA of that year as well as the AAA of prior years. For example, A owns all of the stock in an S corporation having a taxable year ending January 31, and has an adjusted basis in her stock of $20,000. As of February 1, 1983, the corporation had AAA of $10,000 and AE&P of $12,000. For its taxable year ending January 31, 1984, the corporation had operating profits of $10,000. On December 15, 1983, it

51 I.R.C. § 1368(c)(1).
52 I.R.C. § 1368(e)(3).
53 I.R.C. § 1368(e)(2).
54 I.R.C. § 1368(c)(3).
55 I.R.C. § 1368(e).
56 Id.
57 Because tax exempt income does not increase AAA, there is a potential trap in an S corporation investing in tax exempt bonds. See supra text at II.
distributed $25,000 to A. A has to report $10,000. On December 15, 1983, it distributed $25,000 to A. A has to report $10,000 of operating profits to be taxed in her year 1984. She also has to report dividend income of $5,000 to be reported in the year of receipt which is 1983. The computation of the dividend income is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Corporate Accounts</th>
<th>Shareholder’s Stock Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AAA</strong></td>
<td><strong>AE&amp;P</strong></td>
<td></td>
</tr>
<tr>
<td>Balance, 2/1/83</td>
<td>$10,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Operating profits for tax year ending 1/31/84</td>
<td>10,000</td>
<td>0</td>
</tr>
<tr>
<td>12/15/83 distribution:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return of capital (AAA)</td>
<td>(20,000)</td>
<td>0</td>
</tr>
<tr>
<td>AE&amp;P (2nd)</td>
<td>0</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Balance, 2/1/84</td>
<td>$ 0</td>
<td>$7,000</td>
</tr>
</tbody>
</table>

Note that a distribution during a taxable year may be out of AAA as determined as of the end of that year, including the AAA of that year.62

**Order of Adjustments to AAA and of Withdrawal of AAA.** If the order of adjustments to AAA is relevant, as when there is a shift in ownership or as when distributions relating to one corporate taxable year fall into two shareholder years, adjustments and withdrawals should be made in the following order.

First, increases and decreases for current income and deduction items, thereby paralleling basis adjustments.63 Second, decreases for distributions, out of AAA, with AAA being allocated in proportion to the respective sizes of the distributions (except as provided in the regulations). If net deductions are sufficiently high, it will be possible to have a negative AAA.

**Prior Years.** The principal consequence of a negative AAA from prior years is that such an amount will offset subsequent positive AAA. Under one view, there cannot be future tax-free distributions, even out of current years’ until the negative AAA from prior years has been offset.

**Current Year.** If the view is taken that there can be separate current AAA, much as there is a separate current E&P, how should the combination of negative current AAA with positive prior years’ AAA be handled? For example, if for

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61I.R.C. § 1368(c).
62Id.
the year 1985 a corporation has negative current AAA of $36,500, has prior years’ AAA of $20,000, and makes a distribution of $20,000 on January 31, 1985, the distribution apparently is taxable in full on the ground that there is no positive AAA because the full current negative AAA applies retroactively.

For taxable years beginning before January 1, 1983, there was no corporate level AAA. The analogous account was previously taxed income (PTI), which was personal to each shareholder taxed on undistributed corporate earnings and therefore was nontransferable. It is possible that shareholders of a corporation with AE&P will individually have PTI from years covered by the former law, since PTI had not been withdrawn by the time that the new rules became effective. Former law permitted PTI to be withdrawn ahead of AE&P, but only through cash distributions. Moreover, the new law permits such withdrawal of PTI before AE&P, but it is not clear whether PTI is withdrawn before AAA, or vice versa. Under one view, AAA should be withdrawn before PTI, because this will preserve the special status of PTI as benefiting only the shareholder taxed thereon.

Example. If a corporation has AE&P of $20,000, and AAA of $20,000, and two shareholders, one with PTI of $10,000 and the other with no PTI, how are the shareholders taxed if the corporation distributes $20,000 to each? If AAA is distributed before PTI, then the shareholder with PTI would have only a return of capital distribution, while the shareholder without PTI would have a distribution taxed $10,000 as a return of capital and $10,000 out of AE&P. On the other hand, if PTI is withdrawn before AAA, then both shareholders would have a distribution taxed $15,000 as a return of capital and $5,000 out of AE&P.

If PTI of a shareholder is negative, this fact should not affect the shareholder’s ability to withdraw AAA. Further, if there is negative AAA, this fact should not affect a shareholder’s ability to withdraw PTI. Finally, the making of the AAA by-pass election should not affect the ability to withdraw PTI; and the making of the PTI by-pass election should not affect ability to withdraw AAA.

C. Property Distributions.
The amount of the distribution under the above rules is the face amount of cash and the fair market value of noncash property. Noncash property will take a basis to the distributee equal to its fair market value, and similarly, to the extent out of AAA or otherwise not out of AE&P, will reduce AAA and the distributee’s stock basis by the property’s fair market value. Noncash property, to the extent out the AE&P, will reduce AE&P by the property’s basis,

*Former I.R.C. §§ 1375(d) and (f) (1958).
*I.R.C. § 1379(c).
*None of the foregoing positions is authoritative.
adjusted by any gain or loss recognized to the distributing corporation. 67

A distribution of appreciated property by an S corporation results in gain recognition by the corporation as if the property were sold to the distributees at its fair market value. 68 This provision does not apply to complete liquidations and to nontaxable acquisitions and divisions (except for appropriated property distributed as boot). 69

The gain recognition on the distribution of appreciated property will pass through to the shareholders and retain its character. However, if the property involved is depreciable property, the gain could be converted to ordinary income under section 1239.

Example. An S corporation distributes real property worth $105,000 to its four unrelated shareholders, each of whom owns 25% of the stock in the corporation. The property has a basis of $80,000 in the hands of the corporation and is subject to a mortgage obligation in the amount of $100,000. The property is section 1250 property and, if sold at fair market value, would give rise to depreciation recapture of $10,000. The distribution of the property gives rise to a recognized gain of $25,000 ($150,000 amount realized — $80,000 basis), of which $10,000 is ordinary income and $15,000 is section 1231 gain. The $25,000 gain will pass through to the shareholders and retain its character. The amount of the distribution to the shareholders is $5,000 ($105,000 fair market value — $100,000 mortgage assumed by the shareholders), which will be taxed under the rules discussed previously (i.e., if the corporation has current year AAA of $25,000, the $5,000 distribution would be tax free). The total basis of the property to the shareholders is $105,000, or in other words, its fair market value.

Example. Same as above, except the corporation has only one shareholder. The entire $25,000 recognized gain is ordinary income under section 1239.

D. Post-Termination Transition Periods.

When the election terminates, the Subchapter C rules for distributions generally are applicable, including the rule that distributions are first out of current E&P. 70 Under present rules, however, cash distributions with respect to stock during either of the post-termination transition periods, as defined below, can be return of capital distributions to the extent of AAA. While the statute states that the cash distributions shall be applied against and reduce the basis of the stock involved, it is not believed that distributions in excess of stock basis will be outside of the provision. 71

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67 I.R.C. §§ 312(a) and (c)(3).
68 I.R.C. § 1363(d).
69 I.R.C. § 1363(e).
70 I.R.C. §§ 301(c)(1) and 316(a).
71 I.R.C. § 1371(e).
E. Straight Debt.

Although straight debt will not terminate the election, it may be treated as equity under general tax principles. Accordingly, section 1361(c)(5)(C) authorizes regulations to provide for the proper treatment of straight debt under Subchapter S and other provisions of the Code. The Committee Reports indicate that these rules should prevent both tax avoidance and unfair, harsh results for taxpayers. These reports anticipate that straight debt would be treated as debt under Subchapter S, so that corporate income and deductions would not be allocated to the instruments. Interest payments on the instruments would generally be included in the income of the holder and deductible by the corporation. The reports state, however, that interest payments may be examined to determine their character in any situation in which treatment as interest might give the taxpayer an undue tax advantage, such as under the interest exclusion. Further, the reports indicate that the S election will not be treated as an exchange of straight debt for stock. A later repayment of the purported debt might be treated as a dividend out of any AE&P.

Repayment of straight debt by a corporation with AE&P could be treated under one of two alternatives:

(1) Treatment as Debt when Repaid. If basis has been reduced because of net losses, then any gain would be capital gain if section 1232 applies.

(2) Treatment as a Distribution with Respect to Stock. Presumably, the repayment would first be a return of capital distribution out of AAA, unless there is some compelling reason to do otherwise. After AAA is withdrawn, the distribution would be out of any AE&P. Then the remainder of the distribution would be a return of capital distribution.

The preferred alternative would be to treat straight debt as debt when it is repaid. This approach would be in accordance with the expectations of the parties in most cases, would be the least complex approach, would avoid the disproportionate withdrawal of AAA when straight debt is not held in identical proportions as stock, and would avoid withdrawals of AAA entirely whether debt is held proportionately to stock or not.

AE&P Bailout. If straight debt arose during C years and if the corporation has significant AE&P, it is highly likely that the IRS will view the repayment as a form of tax avoidance and treat its repayment as a distribution with respect to stock.

Contribution to Capital. If the basis of debt has been reduced because of the passthrough of net deductions, the contribution of such debt to the cor-

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2Return of capital distributions would be tax free to the extent of basis of stock, which presumably would be increased by the basis of the repaid straight debt.
IV. C Corporations Making the S Election.

Because there generally is no tax cost in making the S election for the corporation or its shareholders, many C corporations will make the S election, principally to pass through to the shareholders the corporation's net deductions or to make substantial distributions with no double tax. However, such corporations and their shareholders will face special problems under the S election.

A. Distributions.

See III., B, D, and E above.

B. Straight Debt.

See III., E above.

C. Adjusted Basis Limitation on Net Deduction Passthrough.

The adjusted basis limitation of section 1366(d) on the net deductions passthrough could be a problem for shareholders of an S corporation with prior C history. Because such a corporation is likely to have considerable AE&P, the inside (corporation's) basis in assets could be significantly greater than the sum of the outside (shareholders') basis in stock and debt, giving rise to excessive net deductions. While a shareholder's net deductions in excess of his basis in stock and debt carries over to subsequent years and is not entirely disallowed as under the former law, the shareholder nevertheless might prefer to utilize net deductions currently. Here are some steps that can be taken.

1. Direct Loans.

Courts have given a strict construction to the concept of adjusted basis in debt. They require that the corporation be under an existing unconditional and legally enforceable obligation to pay the shareholder, that the debt run directly to the shareholder, and that the shareholder have made through the debt an "actual investment" or "actual economic outlay." A basis giving indebtedness does not arise when a shareholder merely guarantees the debt of his corporation, executes a surety agreement with respect to the debt, or becomes an accommodation party or co-maker. Thus, alternative arrangements should be sought. If funds are to be furnished by outsiders...

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1See supra text at II.
2See supra text at I for problems relating to proven oil and gas properties.
3See Note, Section 1374(c)(2) and the Actual Investment Limitation on NOL Pass-Through to Subchapter S Corporation Shareholders, 30 TAX LAW. 790, 792 (1977).
and the shareholders will bear ultimate liability for nonpayment, the shareholders should borrow the funds from the outsiders and in turn loan the funds to the corporation. Further, if there is an existing guaranty, the shareholders should satisfy the debt by cash payment or by substitution of shareholder notes for the corporation’s note.79

Because it is required that the debt be directly owing to the shareholder who has the net deductions passthrough, it is not sufficient that the debt be owing to a related party, such as a relative, a partnership, a trust, an estate, or another corporation.80 One obvious solution to the adjusted basis limitation problem in this context is to have the shareholder borrow money from the related party in a bona fide loan and then directly loan the funds to the electing corporation. Another solution is for the related party to make a bona fide transfer of the debt to the shareholder; whether by gift, distribution, or otherwise.

In addition to those steps suggested under “direct loans” above, the shareholders should consider the following steps:

One possible step to increase basis in stock or debt is to make additional investment in the corporation. Funds for such an investment could be obtained from a related party by gift, distribution or borrowing. In this connection, it is not possible under Subchapter S for a shareholder to make an investment in stock or in debt solely by giving his indebtedness in return therefore to the corporation. In such a case, the shareholder makes an investment when and to the extent that he pays the debt to the corporation. Further, the IRS might attack the following arrangements as ineffective shams: (i) a short-term investment of cash made shortly before the end of the corporation’s taxable year in which there is a net deductions passthrough which is withdrawn shortly after the beginning of the next taxable year; and (ii) an investment of property unrelated to the business of the corporation.

A second approach to avoiding or minimizing the adjusted basis limitation is to prevent the reduction of basis. This approach basically avoids the reduction in basis of stock by the device of not making return of capital dividend distributions. Shareholders could borrow funds from the corporation. If the arrangement is classified as a loan to the shareholder and not a dividend, his basis in stock is not thereby reduced. While a loan classification cannot be guaranteed, it would be helpful if the loan is evidenced by a note having a definite maturity date and providing for the payment of interest. The parties should treat the transaction as a loan on their financial records. Interest and principal should be paid according to the terms of the note, and thus the

79See Rev. Rul. 75-144, 1975-1 C.B. 277. But see Underwood v. Comm’r., 535 F.2d 309 (5th Cir. 1976). aff’g. 63 T.C. 468 (1975), for the proposition that it must be clear that the original creditor would make a demand upon the shareholder-debtor for payment of the substituted note.

loan should be only in an amount which the shareholder can handle.81

It might be possible, based on a technical reading of section 1367(b)(2)(A), to avoid the adjusted basis limitation through a distribution of appreciated property. It is implicit in the provision that adjustments to basis occur in the following order: first, net income or net deductions (that is, deductions in excess of income); and second, return of capital distributions out of AAA. A distribution of appreciated property would give rise to recognized gain which would reduce the amount of net deductions although the character of operating losses and section 1221 or 1231 gain would be retained. The gain would give rise to AAA as a source of return of capital distributions only to the extent that there was a net income. However, if there is no AAA, the amount of distribution could be out of AE&P. For example, an S corporation predicts an operating loss of $75,000 for its calendar year 1983. The corporation has no AAA, but it does have AE&P of $250,000. Its one shareholder, A, has stock with a basis of $20,000 and debt with a basis of $30,000. In late December, 1983, the corporation distributes section 1231 property worth $105,000, having a basis of $80,000 in the hands of the corporation, and subject to a mortgage obligation in the amount of $100,000. The property is unimproved real estate. The distribution of the property gives rise to a recognized section 1231 gain of $25,000 ($105,000 amount realized — $80,000 basis). The $25,000 gain will pass through to A and retain its character. The corporation thus has net deductions of only $50,000, and A will deduct the $75,000 operating loss and include the $25,000 section 1231 gain currently. A’s basis in stock and in debt will be zero. The amount of the distribution is $5,000, which will be taxed as ordinary income out of AE&P because there is no AAA. The total basis of the property to A is $105,000. Thus, under the special facts of this example, A has current use of an additional operating loss of $25,000 and includes additional income in the amount of $25,000 section 1231 gain and $5,000 dividends, results which might be worthwhile if A intended to sell the property in the near future or if other special circumstances were present.

If a shareholder’s adjusted basis in his debt has been reduced by the net deductions passthrough, repayment of the debt will give rise to gain in the amount of such reduction. However, this gain can be avoided by subsequent net income taxed to the shareholder, as this item first increases the basis of debt under section 1367(b)(2).

If the debt is repaid in installments, the gain is pro rated over all payments, according to the ratio of each payment to total payments. This is in contrast to an approach which first recovers basis before any gain is recognized.82

It has been held that in measuring the gain on repayment of debt, each advance and each repayment is to be treated as a separate and complete

81Haber v. Comm’r., 52 T.C. 255 (1969), aff’d 422 F.2d 198 (5th Cir. 1970).
82Smith v. Comm’r., 48 T.C. 872 (1967), aff’d 424 F.2d 219 (9th Cir. 1970). See supra text at I.
transaction. Thus, repayments and new loans should not be netted.

The gain on repayment of open accounts will be ordinary income, even if the debt is a capital asset, because there is no sale or exchange as required for capital gains treatment. By contrast, the gain on the repayment of bonds, notes, debentures, and other written debt instruments held as capital assets will give rise to capital gain, because section 1232 imputes a sale or exchange. The clear tax planning lesson is that debt to a shareholder should be evidenced by a note initially or should be converted to a note at the end of each taxable year or on some other systematic basis. It is desirable that the debt qualify as straight debt and thus avoid termination problems. It is also desirable that the debt not have a short maturity, so that any gain on repayment will be long-term capital gain and that subsequent net income passthrough will increase the basis of the debt and thereby minimize or avoid gain on repayment.

A charitable contribution of zero or low basis debt held as a capital asset could have tax advantages. Through a contribution of such debt, the shareholder is able to avoid a tax on its repayment while securing a deduction for its fair market value. Further, if the shareholder disposes of all debt having a basis reduced by the net deduction passthrough, any basis increases from the net income passthrough will apply to his stock instead of debt first. In such case, any subsequent dividends could be tax-free out of stock basis.

A more basic problem for tax planning is whether additional investment should be made in debt or in stock, and whether shareholder debt should be converted to common stock periodically when net deductions have occurred or are anticipated. In this limited context, the position of stock is more favorable.

Stock has clear rules for basis increases under section 1367, while debt does not. For example, it is clear that increases are made to stock basis before distributions with respect to stock are taken into account, clearly reducing the amount of gain thereon, while a similar approach apparently is not used for debt. But, note that increases to basis from net income taxed to the shareholder are made first to restore the basis of debt previously reduced by the net deductions passthrough.

If S corporation stock becomes worthless during a year, the loss passthrough reduces basis before the worthlessness deduction under section 165. The 1984 Act provides a comparable rule for shareholder debt covered by section 166.

Cornelius v. Comm'r., 494 F.2d 465 (5th Cir. 1974).
See supra text at III.A, and B.
I.R.C. § 1367(b)(3).
Id.
2. Post Termination Rules

There is a carryover of the excess net deductions after the termination of the S election to be used at the end of either of two post-termination transition periods if a shareholder's basis in his stock has increased as of the end of either or both of these periods.99

Each of the two post-termination transition periods ends with a date on which the excess net deduction passthrough potential may be deducted and also sets out a period of time for post-termination return of capital distributions.90 The two post-termination transition periods are as follows:

a) The period beginning after the termination of the S election and ending on the later of one year after such termination of the due date for filing the return for the last S year; and

b) The 120 day period which begins with the date of a determination that the S election has terminated, the determination being by final court decision, closing agreement, or other agreement between the corporation and the IRS.

Example. Assume that a calendar year corporation's S election terminates on February 5, 1984, by reason of there being an ineligible shareholder. The S and C returns for the taxable year 1984 are filed on March 1, 1985. The first post-termination transition period would begin on February 5, 1984, and would end on the later of February 4, 1985 (one year after termination) or March 15, 1985 (the due date for the last S return). In this case, it would be March 15, 1985. It is not clear whether or when the second period would begin or end, because no formal action was taken by closing or other agreement. Arguably, the filing of a C return on March 1, 1985, would be considered equivalent to an agreement, and the second period would begin on March 1, 1985, and end on June 28, 1985 (120 days after the definitive action indicating termination), although this is not certain. Thus, under the facts assumed, the shareholders arguably could deduct the excess net deductions from S years not only on March 15, 1985, but also on June 28, 1985, if the adjusted basis in their stock were sufficient.

Because the post-termination rules apply only to stock basis and not to debt basis, sound tax planning requires consideration of the conversion of shareholder debt into common or preferred stock during the post-termination transition periods. An exchange of debt for stock is desirable, in contrast with a contribution of the debt to the capital of the corporation. The contribution of the debt could give rise to the income recognition to the corporation and thus to the shareholders by the excess of the debt's face amount over the shareholder's basis.91

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99I.R.C. §§ 1366(d)(3) and 1377(b).
90This was discussed in the text supra at III,D.
91I.R.C. § 108(e)(b). See supra text at III,E.
The post-termination rules apply only to net deductions carried over because of the adjusted basis limitation and not because of the "at risk" limitation at the shareholder level. It is thus desirable that a shareholder's amount at risk not be less than his adjusted basis in stock and debt. In this connection, one method for increasing a shareholder's basis without a corresponding increase in his amount at risk is for him to make a cash contribution to the corporation with cash borrowed by a nonrecourse loan secured by his corporate stock. Another method is for him to make a cash contribution with cash borrowed from a related party or from a fellow shareholder.

D. At Risk Limitation.

1. Shareholder Level.

A shareholder's current use of the net deductions passthrough is also contingent on his having an adequate amount at risk under section 465. Because the shareholder's amount at risk largely parallels his adjusted basis in stock and debt, the matter will not be discussed further.

2. Corporate Level.

The "at risk" limitation on net deductions is not applicable at the S corporation level.

E. Some Surprises for the Corporation.

1. Fringe Benefits.

The partnership rules are expressly made applicable to fringe benefits for taxable years beginning after December 31, 1982. For purposes of applying the income tax laws relating to fringe benefits, the S corporation is treated as a partnership and any shareholder who owns directly or indirectly more than 2% of an electing corporation's stock is treated as a partner.

The Code does not define the term "fringe benefit," although the Committee Reports for section 1372 give examples such as: (i) meals and lodging under section 119, (ii) premiums paid on group-term life insurance under section 79, and (iii) payments for and under accident and health plans under sections 105 and 106. The coverage of section 1372 undoubtedly is not limited to statutory fringe benefits and thus could reach many items arguably excluded for administrative reasons, such as free parking and employee discounts. However, the provision should not reach incentive stock options under section 422A, because an employer deduction is not matched by an employee exclusion thereunder.

"See infra text at IV,D.
"Prop. Reg. §§ 1.465-8(a) and 1.465-20(a) (June 5, 1979).
"I.R.C. § 1372.
S corporations with an election effective as of September 28, 1982, can retain their existing fringe benefits for taxable years beginning before January 1, 1988, so long as the former 20% passive investment income test is not violated, the election does not terminate, and there is not a threshold shift of ownership within the meaning of the taxable year grandfather clause.97

2. Carryovers.

There can be no carryover from C years to S years and vice versa although an S year is treated as an elapsed year for purposes of determining the number of taxable years to which an item may be carried back or forward. Thus, if a corporation having a NOL (Net Operating Loss) carryforward from the C year 1976 is an S corporation for the years 1984 through 1986, the NOL carryforward cannot be used in 1984 through 1986, and the fifteen year carryforward period continues to run during the S years and will expire after 1991.98

3. Related Persons.

Under section 267, if there are unpaid expenses and interest of an S corporation owing to a cash method related person, the corporation is not permitted a deduction until the item is included in the income of the related person.99 For purposes of deferral, related persons include all shareholders. The foregoing rule in effect places the corporation on the cash method when the related creditor uses the cash method. The deferral approach for unpaid expenses and interest of an S corporation debtor is to be contrasted with the usual disallowance rule of section 267(a)(2).

Example. An accrual method calendar year S corporation has a liability for $5,000 unpaid interest to a cash method shareholder for the year 1984. This amount is not paid until June 30, 1985. If the shareholder owns directly or indirectly at least 2% in value of the stock, the interest expense must be taken as a deduction in 1985 and not in 1984.

If the S election terminates while deduction of expenses has been deferred under section 267, the deferred deduction should continue to be available to the corporation. It should not be considered a prohibited carryover, because section 267(f) does not refer to the deferral as a carryover. Further, section 267(f) does not require continuation of the S election.

Regardless of the amount of the passthrough of the S corporation's items, the IRS may make adjustments to take into account the failure to pay reasonable compensation for services or for the use of capital among family members, whether or not they are shareholders.100 Could this rule be avoided in the family context by the practice of accruing a liability to a family member but securing...
indefinite deferral under section 267(f) by not paying the liability? The answer to this question is not clear. However, it should be noted that section 1366(e) provides for such adjustments "...as may be necessary in order to reflect the value of such services or capital."\textsuperscript{101}

Each shareholder must report his share of the passthrough items of income, deduction, and credit of an S corporation's taxable year in his taxable year in which or with which the corporation's year ends.\textsuperscript{102} Thus, the taxable year of the corporation is important in the timing of reporting at the shareholder level. For example, an S corporation with one shareholder has a taxable year ending January 31. It has AAA of $5,000 as of February 1, 1983. For its year ending January 31, 1984, it has operating income of $24,000, of which $23,000 was earned in the first 11 months. Also, the corporation made only one distribution to its shareholder during the taxable year; a distribution of $20,000 on December 15, 1983. The distribution is nontaxable, and the shareholder has to report all of the $24,000 of operating income for his calendar year 1984 and none for 1983. The approach of the partnership rules toward the entity's choice of taxable years is generally used for S corporations. A corporation electing Subchapter S after October 19, 1982, is permitted to use as its taxable year only the calendar year or an accounting period for which it establishes a business purpose.\textsuperscript{103} If a corporation having a taxable year other than the calendar year wishes to elect Subchapter S but retain its taxable year, what approaches can it use?

A corporation may adopt, retain, or change to a taxable year other than a calendar year if shareholders holding more than one-half of the shares of its stock have the same year or are concurrently changing to it.\textsuperscript{104}

A corporation may adopt, retain, or change to a taxable year other than a calendar year if shareholders holding more than one-half of the shares of its stock have a taxable year or are concurrently changing to a taxable year that results in a deferment of income to each of these shareholders of three months or less.\textsuperscript{105} Thus, if a sufficient number of shareholders use one calendar year, the corporation could adopt, retain, or change to a taxable year ending September 30, October 31, or November 30.

There have been reports that tax-wise parents are placing their children on taxable years ending in November 30.

A corporation may adopt, retain, or change to a year other than a calendar year if the year coincides with the corporation's natural business year.\textsuperscript{106}

\textsuperscript{101} Id.
\textsuperscript{102} I.R.C. § 1366(a)(1).
\textsuperscript{103} I.R.C. § 1378(b).
\textsuperscript{105} Id.
\textsuperscript{106} Id.
A taxable year is a natural business year if it meets the 25% test for each of the immediately prior three taxable years:

\[
\text{Gross Receipts from Sales and Services for Last Two Months of Year} \times \frac{\text{Gross Receipts from Sales and Services for Entire Year}}{\text{Gross Receipts from Sales and Services for Entire Year}} = 25\%
\]

(1) If the corporation qualifies for more than one natural business year, the taxable year permitted ends with the two-month period for which the highest average percentage of gross receipts is achieved for the prior three taxable years.

(2) Many corporations with substantial passive investment income will seek to avoid the penalties on excessive passive investment income by acquiring low risk businesses which generate sufficient gross receipts of a nonpassive nature. It is desirable to consider the effect on the natural business year computations when acquiring a new business, for example, the choice between a ski shop, a surfboard rental business, and a grocery store.

F. Penalties on Excessive Passive Investment Income (EPII).

The new law contains two penalties on excessive passive investment income (EPII) of corporations with AE&P from C years. One penalty imposes a special tax, while the other penalty terminates the election.

1. The Section 1375 Tax on EPII.

The section 1375 tax on EPII is potentially applicable to a corporation in any taxable year in which it has AE&P from C years at the close of the year. The section 1375 tax is imposed at the highest corporate tax rate, currently 46%, on a base which is the smaller of excess net passive income (ENPI) or the corporation's taxable income. ENPI is determined as follows:

\[
\text{ENPI} = \text{Net Passive Income} \times \frac{\text{EPII}}{\text{Passive Investment Income}}
\]

EPII in the above formula is passive investment income in excess of 25% of gross receipts. Net Passive Income means passive investment income less the deductions "directly connected" therewith.

Example. An S corporation has passive investment income of $40,000, deductions directly attributable thereto of $4,000, gross receipts of $60,000, and taxable income of $30,000. Thus, its net passive income is $36,000 ($40,000 - $4,000), its EPII is $25,000 ($40,000 passive investment income - $15,000)

107See infra text at IV,F.
108The 1984 Act gives the Secretary authority to waive the section 1375 tax if the S Corporation determined in good faith that it had no current E & P (earnings and profit) at the close of the taxable year and subsequently distributed such E & P within a reasonable period of time of determining its existence. I.R.C. Section 1375(d).
109Cf. I.R.C. §§ 512(a)(1) and (b)(1) and (2); and Treas. Reg. § 1.512(a) - 1(a) (1967).
(25% of $60,000 gross receipts), and its ENPI is $22,500, determined as follows:

\[
\text{ENPI} = \frac{\$36,000 \times (\$40,000 - \$15,000)}{\$40,000}
\]

The section 1375 tax is $10,350 (46\% \times \text{the lesser of $22,500 ENPI or $30,000 taxable income}).

**Example.** Same as above, except that the S corporation’s taxable income is only $20,000, which is less than the ENPI of $22,500. The section 1375 tax is only $9,200 ($20,000 \times .46).

While the section 1375 tax may be imposed only if there is EPII (i.e., passive investment income greater than 25% of gross receipts), the tax is not imposed on EPII. For instance, in example (1) above, EPII is $25,000, but the base for the tax is only $22,500. Further, the tax base is limited to the corporation’s taxable income.

Special rules are provided to avoid a double tax under section 1375 and the corporate level tax on long-term capital gains. Further, any tax imposed under section 1375 reduces the passthrough of passive investment income to the shareholders.110

2. Gross Receipts; Passive Investment Income.

Gross receipts in determining EPII is similar, but not identical to, gross income. It is based on the taxpayer’s method of tax accounting, but tax exempt income is included in gross receipts. Moreover, there is no subtraction of cost of goods sold. There is also no subtraction of basis on the sale of an asset, except that only gains from the sale of section 1221 pure capital assets and of stock and securities whether pure capital assets or not are considered.111

Passive investment income in determining EPII generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and gains from sales of section 1221 pure capital assets and of stock and securities. However, *rents* are not included if the corporation performs significant services, as in the case of a motel or in the case of equipment leasing when the corporation performs maintenance services. *Interest* income generally is to be included even if tax exempt; but interest is not included if it arises out of the sale of inventory or out of a lending or finance business as defined under section 542(d)(1) of the personal holding company tax.112 *Oil and gas royalties* are included using the definition of “mineral, oil and gas royalties” found in Treasury Regulation section 1.543-1(b)(1)(ii) and (iii).113 Royalties would in-

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110 I.R.C. §§ 1375(c)(2) and 1366(f)(3).
clude advance royalties, net profits retained in a leasing transaction, and probably bonuses, and would not include production payments, overriding royalties, net profits retained in a subleasing transaction, and delay rentals.

**Example.** An S corporation with AE&P from C years has the following items bearing on EPII: inventory sales of $50,000, installment payment of $15,000 on the sale of a section 1221 pure capital asset when the gross profit ratio is 60%, interest of $10,000 on the installment payment, and rents of $5,000 when the corporation's services are not significant. The corporation's gross receipts are $74,000 [$50,000 + $9,000 (60% of $15,000) + $10,000 + $5,000] and its passive investment income is $24,000 ($10,000 interest + $9,000 gain on sale of pure capital asset + $5,000 rents). There is EPII of $5,500 [$24,000 - $18,500 (25% of $74,000)].

**Example.** Same as above, except that the installment payment relates to the sale of a section 1231 asset, not a pure capital asset. The corporation's gross receipts are $80,000 ($50,000 + $15,000 + $10,000 + $5,000), and its passive investment income is $15,000 ($10,000 interest + $5,000 rents). There is no EPII.

3. Churning.

Under the structure of the section 1375 tax and of the termination rules discussed below, corporations are encouraged to churn, or sell at short intervals, their assets in order to eliminate EPII. For example, if in the example above, gross receipts were increased to $96,000, there would be no EPII (**i.e.,** the $24,000 passive investment income would not exceed 25% of gross receipts). Thus, if passive investment income does not exceed 25% of the corporation's gross receipts in a year, not only is the section 1375 tax avoided for that year, but the S election cannot terminate for at least three more years since there is no EPII. While churning to increase the amount of gross receipts is not possible with section 1221 pure capital assets, it will be possible with section 1231 hybrid capital assets. Thus, an investment in rental property, a section 1231 asset, could be very useful in minimizing or negating passive investment income through the increase in gross receipts on the disposition of property.

**Example.** An S corporation with four equal shareholders and with AE&P from C years invests in an apartment project during the first year of the election. In the third year of the election, it sells its interests for $5,000 to a third party, at a time when its mortgage obligation on the project is $100,000 and its adjusted basis is $80,000. It has gross receipts of $105,000 ($5,000 + $100,000 discharged debt), and would recognize section 1231 gain of $25,000 ($105,000 amount realized − $80,000 adjusted basis), subject to depreciation recapture. The section 1231 gain is not passive income and thus could not give rise to.
a section 1375 tax, although it could give rise to a corporate level tax on long-
term capital gains.\textsuperscript{114}

\textit{Example.} Same facts as above, except that the corporation distributes the
property worth $105,000 to its shareholders instead of selling the property. The
result is the same, and the shareholders have a basis of $105,000.

The rentals on section 1231 property will not be passive investment in-
come if the S corporation’s services are significant. Moreover, an investment
in rental property would be useful in avoiding the section 1375 tax, but not
necessarily in avoiding termination, if it produces an operating loss, which would
offset the corporation’s income from other sources and thereby reduce or
eliminate its taxable income.

4. Low Risk Businesses.

S corporations will also be encouraged to go into businesses with low
downside risk in order to generate gross receipts. Examples of such businesses
would include a grocery store and a laundromat.

The S election will terminate by reason of EPII if there are three successive
years in which the corporation has EPII and also has AE&P from C years as
of the close of the year. The termination will be effective beginning with the
fourth year.\textsuperscript{115} Planning to avoid termination on this ground probably will center
on efforts to increase gross receipts.\textsuperscript{116}

G. Section 1374 Tax on LTCG.

The section 1374 tax on long term capital gains is designed, among other
things, to discourage the use of short term S elections made to pass through
gains on the sale of corporate operating and investment assets.

This special tax is imposed on an S corporation for a taxable year only
under the following conditions: (i) the taxable income of the S corporation
exceeds $25,000; (ii) the corporation’s net capital gain (net long-term capital
gain in excess of net short-term capital loss) exceeds $25,000; (iii) the corpora-
tion’s net capital gain exceeds 50\% of the corporation’s taxable income; and
(iv) the taxable year is one of the first three taxable years of the S election follow-
ing C corporation status.

Tax planning to avoid or minimize the section 1374 tax might take the
approach of avoiding the convergence of the first three income conditions. In
this connection, use of the installment method could avoid bunching of net
capital gains in the first three taxable years of the S election and perhaps reduce
a year’s net capital gain to $25,000 or less, or to an amount which is less than

\textsuperscript{114}See infra text at IV,G.

\textsuperscript{115}I.R.C. § 1362(d)(3).

\textsuperscript{116}See supra text at IV,F.
50% of taxable income. Further, because one of the methods of computing the tax\textsuperscript{117} in effect uses an annual $25,000 exemption, avoiding the bunching of capital gain could reduce the tax. Tax planning could also take the approach of shifting part of the net capital gain to years following the first three years of an S election, so that such gain is no longer subject to the section 1374 tax. Finally, even though the corporation might be subject to the section 1374 tax on the sale of property, the S election and the gain passthrough on the sale might represent a better alternative than some approach outside of Subchapter S.

If an S corporation is subject to the section 1374 tax, the amount of the tax is the \textit{lesser} of (i) 28\% (the section 1201 rate) of the net capital gain in excess of $25,000, or (ii) the tax at the C corporation rates on the S corporation's entire taxable income. Minimum tax could also be imposed if the section 1374 tax is imposed. Any section 1374 tax and minimum tax imposed on the corporation reduces the passthrough to the shareholders of section 1221 pure long-term capital gains and section 1231 hybrid capital gains, reducing first the section 1221 long-term capital gains.

\textbf{VII. Shareholder Agreements.}

This part of the article will review matters which could or should be addressed in shareholder agreements.

A. \textit{Election and Termination.}

1. Preserving the Election.

Because the S election is relatively easy to terminate, either inadvertently against the wishes of all shareholders or deliberately on the part of minority shareholders against the wishes of the majority, the agreement should attempt to prevent such terminations.

2. Damages for Termination Caused by an Ineligible Shareholder.

A provision for damages on termination caused by an ineligible shareholder will not only be useful in making the aggrieved shareholders whole, but it may also furnish an incentive to all shareholders to take steps necessary to prevent termination; for example, in the drafting of wills and trust agreements.\textsuperscript{118}

The agreement should provide that the person who causes termination by reason of there being an ineligible shareholder, regardless of fault or other circumstances not excepted, should be responsible for damages to the other parties. If the termination is due to transfer of shares to an ineligible shareholder, the person who makes the transfer should be responsible; for example, an estate transferring shares to a residuary trust, even if pursuant to the terms of a will, \textsuperscript{118}

\textsuperscript{117}See infra text at III.G.

\textsuperscript{118}Termination by reason of more than thirty-five shareholders and termination by reason of failure to change taxable years is discussed \textit{infra} at V,A.

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and the officers issuing shares of the corporation. If the termination is due to a shareholder becoming ineligible; for example, a trust loses its eligibility as a qualified Subchapter S trust, then the ineligible shareholder should be responsible.\textsuperscript{11}\textsuperscript{9}

The shares held or transferred by the responsible person should be subject to a lien securing payment of the damages. Such a provision would not only provide security, but it might make an ineligible transferee think twice about purchasing shares.

It would be desirable to set out the factors to be considered in setting damages and/or to provide for liquidated damages. In drafting the provisions for damages, one should address the precise reason for making the S election. In most cases, the reason will be either to pass through anticipated operating losses\textsuperscript{12}\textsuperscript{0} or to avoid double taxation on substantial distributions by a mature corporation.\textsuperscript{12}\textsuperscript{1} One should also bear in mind that any recovery for the loss of a nontaxable or partially taxed benefit will represent fully taxed income to the aggrieved party, thus producing additional tax and a need for additional damages.

In the case of a loss corporation, damages should be provided to the aggrieved shareholders which take into account that the unavailable net deductions passthrough would have saved the shareholders income taxes based on the incremental tax rate applicable to taxable income which it would have offset and that any recovery will be taxed to the shareholder. For example, if we assume an incremental rate of 50\%, the measure of damages should be the sum of 100\% of a shareholder's net ordinary deductions, plus 40\% of her share of net capital losses (or minus 40\% for the share of net capital gains), plus 20\% of her share of section 46 qualified investment.\textsuperscript{12}\textsuperscript{2}

It is generally not appropriate to consider in mitigation of damages the fact that the shareholder does not reduce stock or debt basis by the unavailable net deductions and thus may have to pay smaller taxes on a future disposition of the stock or debt or may save taxes on its worthlessness. The potential tax benefit may be eliminated under the basis rules if the shareholder dies or may occur so far in the future as to have a relatively insignificant present value. It is only if in fact the sale or worthlessness has occurred prior to measurement of damages and there is an actual tax benefit that the benefit should be taken into account.

\textsuperscript{11}It is not felt that it would be practical to base liability on intent of the responsible party.

\textsuperscript{12}\textsuperscript{See supra text at II.}

\textsuperscript{12}\textsuperscript{See supra text at II.}

\textsuperscript{12}\textsuperscript{These percentages were selected to place the incremental 50\% tax rate shareholder in an after tax position comparable to Subchapter S. For example, one dollar of ordinary deductions to such a shareholder would save him fifty cents in taxes. To place him in the same position with a taxable recovery, he would have to receive one dollar in damages.}
It also is not generally appropriate to consider in mitigation of damages the fact that the corporation may reduce its own tax liabilities with the net deductions. The shareholders might never benefit from the tax savings if the corporation becomes insolvent or if distributions are not made or the shareholder does not realize an amount on eventual sale traceable to such saved taxes. Only if a benefit can be traced to such saved taxes prior to damages measurement should there be a reduction in damages.

It should be expressly provided that the aggrieved parties need not take steps to cure an inadvertent termination because it is not clear that this procedure will be interpreted to be helpful in this context. It should also be expressly provided that they need not mitigate damages by being required to exercise any calls on the responsible party's shares, because these shares might not be a good investment. However, the aggrieved party should be required to take steps to make a new election before the five year waiting period has expired, if the corporation otherwise qualifies.

Damages probably should be limited to a five year period, and any future losses for this period should be estimated based on the average of prior losses, unless the responsible party can establish at the time of the measurement of damages that a shorter period or a different measure of future losses is appropriate. The assumed incremental tax rate for an aggrieved shareholder for any taxable year should be assumed to be the highest rate if it is not known at the time of damages measurement, unless the responsible party can establish what the rate is likely to be.

In the case of a mature profitable corporation which would have distributed substantial earnings during an S election, both the corporation and its shareholders are aggrieved parties, but in overlapping ways.

From the shareholder's point of view, the following facts should be considered: the amount of potential dividends is reduced by her share of any additional tax paid or to be paid because of the termination; she is taxed on dividends paid as ordinary income without preserving the character of the corporation's pre-tax earnings; and she does not get the benefit of her share of section 46 property purchased and to be purchased by the corporation. The aggrieved shareholders could be permitted to use the shareholder's viewpoint as the measure of damages. Please observe that because the recovery will be taxable as ordinary income to the shareholders, adjustments will be required to convert each corporate item to ordinary income based on each shareholder's incremental tax rate, as follows:

Net ordinary income — no adjustments required since dividends will be

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121I.R.C. § 1362(g).
122Id.
123If an aggrieved party prior to damage assessment, takes a step which would have made him a responsible party is taken before the S election terminated, his recovery should be limited to the period prior to such event.
taxed as ordinary income.

Net long term capital gains (Net LTCG) — convert to ordinary income. For example, if the shareholder’s incremental rate is 50%, one dollar of net LTCG should be recovered as one dollar and sixty cents, so that the shareholder will have left eighty cents after taxes.

Tax exempt income — convert to ordinary income. For example, if the shareholder’s incremental rate is 50%, one dollar of such income should be recovered as two dollars, so that the shareholder will have one dollar left after taxes.

Ten percent of section 46 property — treat as tax exempt interest.

Example. A former S corporation with two equal shareholders, A and B, has $100,000 of ordinary income and pays a tax thereon of $25,750. The S election was improperly terminated last year when B became ineligible as a shareholder. The amount of damages to A is $12,875 (½ of $25,750) regardless of his incremental rate (A’s incremental rate is 50%). If the election has not terminated, A would have paid $25,000 tax on $50,000 income and could have received $50,000 from the corporation, giving a net amount of $25,000 potential after tax income to A. Now that the election has terminated, A can potentially receive only $37,125 (½ of $74,250) from the corporation which will continue to be taxed as ordinary income when received. A’s share ($12,875) of the $25,750 balance of the corporation’s pre-tax earnings, thus, is the amount of damages necessary to restore A to the position in which he could receive $25,000 after taxes.

Example: However, if the $100,000 income were LTCG and not ordinary income, A would be taxed on only $20,000 of his share of the income (after the 60% deduction) if the S election had not terminated, giving $40,000 potential after tax income to A ($50,000 less $10,000 tax). Because the election has terminated, the corporation not only pays a tax of $25,750, which is less than the tax under the 28% alternate rate, but A’s income potential is now ordinary income instead of LTCG. To restore A to the position in which he can receive $40,000 potential after tax income, he should receive damages of $42,875 ($80,000 ordinary income less one-half of the corporation’s after tax income of $74,250). In determining the incremental rate applicable to a shareholder, if not at 50%, ordinary income should be presumed taxed at each shareholder’s lowest rates, net LTCG next, and tax exempt income including 10% of section 46 property last. In the event that the shareholder’s point of view is elected as the measure of damages, it should be provided that it is immaterial whether or not the corporation pays dividends after termination of the election, so that the parties will not be forced into a double taxation position before recovery is assured.

From the corporation’s point of view, the following matters have changed. The corporation has paid and will have to pay taxes on earnings, including
the recovery, at the regular corporation rates and may even have to pay the accumulated earnings tax on retained earnings. But, it will have the benefit of the investment credit on its section 46 property. The aggrieved shareholders should be permitted to use the corporation's viewpoint as the measure of damages through a derivative suit on behalf of the corporation. An upward adjustment should be made in recognition of the fact that any damages will be ordinary income to the corporation.

Arguably, there could be a mix of recoveries using both viewpoints. Under this approach, the corporation would be permitted to have a full recovery based only on its viewpoint and the shareholders would be permitted a recovery avoiding double taxation at ordinary income rates. For example, a former S corporation with two equal shareholders, A and B, has $100,000 of net LTCG and pays a tax thereon of $25,750. The S election was improperly terminated last year when B became ineligible. To restore the corporation to the position in which it would have $100,000 without paying taxes, the corporation would be entitled to recover $30,488, producing $4,738 in additional taxes for a total of $30,488 in taxes and giving the corporation $100,000 after taxes. Further, A should be permitted to recover $30,000 presently because one-half of the corporation's retained earnings of $100,000 plus the $30,000 to A would eventually give A $80,000 of ordinary income, potentially to give her $40,000 after taxes.

It should be expressly provided that the aggrieved parties need not take steps to cure an inadvertent termination, because it is not clear that this procedure will be interpreted to be helpful in this context. However, it may or may not be provided that they must mitigate damages by being required to exercise any calls on the responsible party's shares. Moreover, the aggrieved parties should be required to take steps to make a new election before the five year waiting period has expired if the corporation otherwise qualifies.

Damages probably should be limited to a five year period, and future income for this period should be estimated based on the average of prior income, unless the responsible party can establish at the time of damages measurement that a shorter period or a different measure of future income is appropriate. The assumed incremental rate for an aggrieved shareholder or for the corporation for any taxable year should be assumed to be the highest rate if it is not known at the time of the measurement of damages unless the responsible party can establish what the rate is likely to be.

The corporation and its shareholders should have the power to prevent

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126 See supra text at V,A.
127 This is less than the tax under the 28% alternative rate.
128 See supra text at V,A.
129 I.R.C. § 1312(g).
130 See I.R.C. § 1378(c).
a transfer to an ineligible shareholder, whether the transfer is by gift, sale, or exchange, or by an estate to an heir.

It should be required that the prospective donor, the estate, or the prospective seller contemplating the transfer to an ineligible shareholder notify the corporation and the other shareholders, who then have the right to purchase the shares at the bona fide offer price if a proposed sale is involved (i.e., a right of first refusal), or, in other cases at a formula price based on book value or a reasonable multiple of earnings, or upon appraised market value. In other words, the agreement would provide that no transfer may be made to an ineligible shareholder unless the stock is first offered to the corporation and the other shareholders at the price indicated above. Such an approach is particularly useful to prevent a transfer to an ineligible shareholder by sale or exchange.

As an alternative, the agreement could provide that any transfer to an ineligible shareholder is ineffective and that the title to the shares automatically vests in the corporation upon the attempted transfer at the price indicated above. Such an approach is particularly useful to prevent transfer by gift or by specific bequest to an ineligible person, if permissible under state law.

In any event, in drafting the formula price and in determining the appraisal price, the drafter of the agreement and the appraiser should consider that net earnings have not been reduced by federal taxes. Failure to do so could result in an overstated net earnings.

It is conceivable, although not typical, that the S election will be made by a corporation with a large number of shareholders. In such a case, the death or divorce of shareholders could pose a threat to the election. The death of a shareholder could pose a threat if the decedent left his shares to multiple heirs. A divorce could create problems if both husband and wife are shareholders, because after divorce they are no longer counted as one shareholder. In the situation in which there is a large number of shareholders, consideration should be given to providing an option to purchase in the corporation and its shareholders on the death or pending divorce of a shareholder. There should be required notification to the corporation and its shareholders of the death or filing of the divorce petition, followed by a specified period in which the shareholders could purchase the shares at a formula price based on book value or a reasonable multiple or earnings, or at an appraised market price.\textsuperscript{11} If the event giving rise to an option is the pending divorce of shareholders, it could be provided that the option applies only to the interest of the spouse not occupying a management position with the corporation. Moreover, damages could be provided for termination involving a failure to follow the notification-option procedure.

Certain grandfathered corporations are permitted to use a taxable year

\textsuperscript{11}See supra text at V,A.
other than the calendar year or a natural business year until there is a threshold cumulative shift of ownership, i.e., a cumulative 50% shift in ownership by nonqualifying transfer, by issuance of new shares by the corporation, by gift to a nonfamily member, or by sale except to a family member pursuant to a qualified buy-sell agreement in existence on or before September 28, 1982. It is not clear whether the election terminates or is merely suspended if a corporation, after being required to change years by reason of a threshold shift in ownership, fails to do so. In either event, the agreement should attempt to prevent such a threshold shift in ownership. The agreement could in effect give each shareholder transfer rights, i.e., the privilege of selling or gifting up to 50% of shares by nonqualified transfer, which transfer rights are assignable. The agreement should provide that if any shareholder transfers more shares than permitted in the agreement and a termination or suspension occurs then or later by reason of a threshold cumulative shift of ownership, he is liable in damages for the increase in taxes resulting from bunching up more than twelve month's results into one taxable year of each shareholder. The agreement should also require that the corporation seek permission to retain its taxable year so that damages may be avoided.

Revocation.

If future revocation is contemplated, the subject should be covered by the agreement.

While the law provides that a revocation may specify a future date, the procedure may prove to be unsatisfactory for two reasons. First of all, if a prospective revocation has been filed but some of the parties have a change of heart, it is not clear whether such a revocation may be recalled or rescinded and, if so, who must consent to such action. A second problem with the statutory procedure for a prospective revocation is that it apparently contemplates a date and not an event and thus could not be triggered by an event such as the reaching of a gross sales target.

A more satisfactory procedure is to specify in the shareholder's agreement the conditions under which a revocation will be filed and to have each shareholder designate an officer-shareholder as his agent to revoke the election when the events or conditions are met. Such an agency power in the officer-shareholder could be made irrevocable, because it would be a power coupled with an interest. The agreement could also deal with circumstances under which the parties could modify the conditions calling for filing of a revocation.

Termination.

The agreement could have several provisions dealing with termination, if and when it occurs.

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132 I.R.C. § 1378(c).
133 A similar approach would be to create two classes of stock, identical in every respect, except that transfer of one class gives rise to potential liability under the agreement.
The per day allocation method is to be used in the absence of consent by all shareholders during the year before and after termination to use the interim closing of books method. The agreement could set out a procedure for determining when the interim closing of books method is to be used and could designate an officer-shareholder as the agent of each shareholder and former shareholder to file consents to this method. The agency power in the officer-shareholder could be made irrevocable because it would be a power coupled with an interest.

The Code sets out a procedure for curing an inadvertent termination which requires, among other things, the consent of all shareholders during the period of the curing. The agreement could set out a procedure for determining whether the curing of an inadvertent termination is to be sought and could designate an officer-shareholder as agent of each shareholder and former shareholder to consent to such curing. The agency power in the officer-shareholder could be made irrevocable because it is a power coupled with an interest.

The Code sets out a procedure for curing an inadvertent termination which requires, among other things, the consent of all shareholders during the period of the curing. The agreement could set out a procedure for determining whether the curing of an inadvertent termination is to be sought and could designate an officer-shareholder as agent of each shareholder and former shareholder to consent to such curing. The agency power in the officer-shareholder could be made irrevocable because it is a power coupled with an interest.

The S Election.

The making of the S election, whether the first or a later one, must be consented to by all shareholders at the time of the filing. Moreover, if the filing occurred on or before the fifteenth day of the third month of a taxable year and is retroactive to the beginning of the year, the election also requires the consent of all former shareholders who owned stock during the year before the time of the filing. The agreement could specify the procedure for determining if the S election is to be made, or the conditions under which it is to be made. The agreement could also deal with the possibility of making the election after termination before the five year waiting period has passed. These provisions are particularly desirable if damages are to be sought upon the termination of an election by reason of an ineligible shareholder or more than thirty-five shareholders. The agreement could designate an officer-shareholder as agent of each shareholder and former shareholder to consent to the election. The agency power in the officer-shareholder could be made irrevocable because it is a power coupled with an interest.

AAA Bypass.

While AAA is normally withdrawn before AE&P, the Code permits an elective withdrawal of AE&P before AAA. This election could be very useful
in purging the corporation of its AE&P, particularly if the AE&P is relatively small in amount, because the penalties associated with EPII could thereby be avoided. This AAA bypass election typically would be made in the early life of the S election in order to avoid the EPII penalties, but it is conceivable that it could be made later; for example, when one or more shareholders has experienced losses in other activities.

A procedure could be set up to determine whether or when to purge the S corporation of any AE&P. The agreement could designate an officer-shareholder as agent of each shareholder to consent to the AAA bypass. The agency power in the officer-shareholder could be made irrevocable because it is a power coupled with an interest.

B. Change in Ownership.

1. Threshold Shift in Ownership.

The problems associated with a threshold shift in ownership have been discussed above at VII, A, 2.

2. Allocation.

The interests of the shareholders are normally determined under the per day allocation method. However, if a shareholder terminates her interest in the corporation, whether by gift, death, sale, or exchange, then all persons who are shareholders during the taxable year may agree to the interim closing of books method. The agreement could set out a procedure for determining when the interim closing of books method is to be used and could designate an officer-shareholder as the agent of each shareholder and former shareholder to file consents to this method. The agency power in the officer-shareholder could be made irrevocable because it would be a power coupled with an interest.

C. Level of Distributions.

If shareholders are to be prevented from terminating the S election, the agreement should also provide for adequate distributions to assist the shareholders in meeting tax liabilities on the net earnings passthrough. Otherwise, the S election could be used by control shareholders with an adequate source of outside income to force other shareholders to sell their shares. Such a provision is particularly useful on the death of a shareholder, when survivors might be cut off from the usual earnings of the shareholder. Because an S election would not normally be made by an S corporation unless substantial distributions were contemplated, the minimum required distribution should be the sum of 50% of net ordinary earnings plus 20% of net long term capital gains and net hybrid capital gains. No adjustment should be made for net capital losses

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139 I.R.C. § 1377(a)(1).
140 I.R.C. § 1377(a)(2).
141 I.R.C. § 1221.
142 I.R.C. § 1231. These percentages assume the highest individual rates.
because it is not certain that these will be utilized by individual shareholders. Also, no adjustments should be made for the corporation’s purchase of section 46 assets giving rise to the investment credit because the investment credit could be recaptured in future years.

D. Entity Level Audit.

The entity level audit procedures for partnerships are generally applicable to S corporations. Based on the partnership provisions, the shareholders’ agreement could cover the following items: the selection, designation, resignation, and removal of an agent to represent the parties in an audit; restriction of the scope of the agent such as by requiring her to act only with the consent of a certain percentage of shareholders; reimbursement of the agent; modification of fiduciary obligations of the agent; communication between the agent and the shareholders; and settlement restrictions on shareholders.