AN ANALYSIS OF S CORPORATIONS AS ONE TYPE OF BUSINESS ENTITY

An Honors Thesis (ID 499)

by

Jane A. Puetz

Thesis Director

Robert W. Walker

Ball State University
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This project is dedicated to my parents, Leonard and Irene Puetz, who encouraged me to research this topic.
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I. REASONS FOR CHOOSING THE S CORPORATION ROUTE

According to Section 1361 of the Internal Revenue Code, "the term 'S Corporation' means, with respect to any taxable year, a small business corporation for which an election under Section 1362(a) is in effect for such year." Translated into layman's terms, a S Corporation is a hybrid business entity that combines certain features of partnerships and corporations; greater flexibility is derived from the partnership form while operating advantages are taken from the corporation. In 1958, Congress enacted the first provisions relating to Subchapter S Corporations. The major intent was to allow small corporations to get the benefit of partnership-like taxation while still remaining with the corporate form.

A. ADVANTAGES OF THE S CORPORATION FORM

The S Corporation form of operating a business has several advantages. Probably the major advantage is the avoidance of double taxation; regular corporations' profits (hereafter referred to as C Corporations which are governed by Subchapter C of the Internal Revenue Code) are taxed to the corporation when earned and to the shareholder when dividends are paid out. Another benefit is that shareholders in an S Corporation get immediate deduction for losses because the corporate-level losses are "passed through" to the individual shareholders. Another advantage for S Corporations is that
they are not subject to any accumulated earnings penalty. S Corporation shareholders pay the tax when the income is earned, allowing the corporate income to accumulate without restriction and to be paid out later to the shareholders without any tax to the extent of their stock and debt basis.

One more positive aspect of operating as an S Corporation is the ability to transfer business profits to family members in lower tax brackets, annual gifts of non-voting stock can easily be made to children with the parents retaining the stock with the voting rights. Yet another benefit concerns the deductibility of charitable contributions at the corporate level. C Corporations must limit their deduction to 10 percent of taxable income. S Corporations' shareholders are allowed to deduct their portion of the charitable contributions up to the limit permitted on individual charitable contributions. Some of the nontax advantages of the S Corporation form of operations include limited liability, continued existence and the ease of transferring interests.

B. DISADVANTAGES OF THE S CORPORATION FORM

The S Corporation status also has its disadvantages. When the S Corporation form of operations is used, the overall structure of the business is limited. For example, the maximum number of shareholders that an S Corporation may have is only thirty-five. This often places constraints on how the company may raise capital. If capital is to be raised from a wide variety of sources, the form of business that
will allow a large number of investors should be chosen. Along this same line, S Corporations may only issue one class of common stock. The qualifying characteristics for S Corporation stock will be discussed later in this paper. C Corporations may issue preferred, common and convertible stock without any restrictions, and partnerships may provide for an unlimited number of interests in the partnership agreement. S Corporation stockholders must also meet strict requirements to be eligible stockholders. Another drawback of S Corporations is the limitation on the selection of a taxable year; S Corporations and partnerships must operate on a calendar-year basis unless they can establish a valid business purpose for a different taxable year. Many fewer restrictions are placed on C Corporations when the choice of operating on a fiscal-year basis is made. Yet another disadvantage of the election of S Corporation status is the restriction place on fringe benefits. Shareholders with a 2 percent or more interest in the corporation are not eligible for tax-sheltered fringe benefits allowed to C Corporations. Such fringe benefits include medical insurance premiums, medical reimbursement plans, the cost of the first $50,000 of group-term life insurance, accident and health plans and employer-provided meals and lodging. The S Corporation form of business also discourages the reinvestment of corporate income. This disadvantage might cause severe problems for businesses that must reinvest earnings for expansion purposes. Shareholders are discouraged to reinvest in the company when
in S Corporation status because they are liable for the tax on undistributed corporate income. One additional negative aspect of S Corporation election is the forfeiture of C Corporation graduated tax rates; corporate tax rates on the first $100,000 of corporate income are lower than the corresponding rates for individuals. Individuals may be taxed up to the 50 percent while the highest corporate tax rate is 46 percent.  

Arthur Andersen & Co. conducted a study for the National Association of Wholesaler-Distributors (NAW) to analyze the impact of the Treasury proposed flat 33 percent corporate tax rate on the small to medium-sized wholesaler-distributor corporations. In their analysis, Arthur Andersen also addressed the election of S Corporation status as a means to avoid tax increases that might occur. One substantial limitation to the widespread use of S Corporations for operating businesses they found was that a certain degree of sophistication in tax knowledge was necessary for small business owners and their tax advisers to understand the tax code and to avoid many of the potential traps. Because of this limitation, Arthur Andersen felt that many of the small business owners "shyed away" from S Corporations because of "fear of the unknown."

C. SUBCHAPTER S IN PERSPECTIVE

The first provisions of Subchapter S law enacted in 1958 contained many complex formulas which were used to incorporate
the different operating principles taken from partnership and regular corporation regulations. It also consisted of safeguards to prevent potential abuse by taxpayers. The complexity of the system and the risk of error or uncertainty of involuntary termination had caused many practitioners to avoid Subchapter S unless they were fully prepared to devote significant amounts of time and effort into the constant supervision of the company's operations. As a remedy to this situation the Subchapter S Revision Act of 1982 (SSRA) was enacted on October 19, 1982, when President Reagan signed Public Law 97-354.

What were previously known as "Subchapter S" or "Small Business Corporations" are now known as "S Corporations" under SSRA. The major goal of SSRA was to reduce the tax treatment differences between an S Corporation and a partnership. In addition, SSRA planned to eliminate some of the traps that had previously caused unintentional termination of the S Corporation election and to prevent the taking of unwarranted benefits by individual shareholders. One example of such unwarranted benefits by individuals is the deferral of income of up to eleven months by the manipulation of the corporation's and the shareholders' tax years. The 1982 Revision Act significantly moved toward simplification and taxation that more closely resembles the principles of partnership taxation. This move resulted in the direct passing through to shareholders of items of business income,
deductions and credits rather than only items that were considered investment dividends. S Corporation status has become a more favorable means of business operation that small businesses should seriously consider. SSRA is generally effective for tax years beginning after December 31, 1982.

D. OTHER LEGISLATIONS AFFECTING S CORPORATIONS

The Subchapter S Revision Act of 1982 was not the only piece of legislation that affected the decision to choose the S Corporation status. The Economic Recovery Tax Act of 1981(ERTA) brought about a reduction in the highest individual marginal tax rate from 70 percent to 50 percent. This reduction helps to close the gap between individual and corporate rates; the highest corporate rate is 46 percent. When double taxation on corporate income is compared to individual taxation, the after-tax income remaining is often greater at the individual level. An example illustrates this: assume a corporation has taxable income of $500,000. The corporate tax on this income would be $209,750. The tax to an individual shareholder in the 50 percent bracket would be $145,125(.50($500,000-209,750)). Profits remaining after taxes would be $145,125. With an S Corporation, there is no corporate income tax; therefore, the business owner pays $250,000 in income tax at the maximum individual tax rate of 50 percent. By operating the company as an S Corporation, $104,875 of additional profits were available($250,000-145,125).
S Corporation rules were also affected by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This Act changed the treatment of pension plans by increasing the amount of money a business owner can invest back into the company for retirement. Subchapter S elections became more desirable as a result of this. TEFRA attempted to resolve the differences that existed between the amounts that could be set aside in a qualified retirement plan for the sole proprietor, the partnership, and the corporation. In the past, the regular corporation owners were allowed to set aside larger amounts in qualified plans than were sole proprietors and partnership owners. After January 1, 1984, owners of S Corporations may contribute the lesser of $30,000 or 15 percent of earned income to a qualified profit-sharing plan, which is an increase of about two times. Cost-of-living adjustments were scheduled for future years.

One additional law that has brought about changes to the entity of S Corporations was the Deficit Reduction Act of 1984 (DRA). DRA made over thirty changes to the S Corporation provisions enacted by the Subchapter S Revision Act of 1982. These changes were effective, unless otherwise specified, as of the date of the SSRA of 1982. One such group of changes affects S Corporations with a prior C Corporation history. The benefits of certain preference items under Section 291 of the Internal Revenue Code have been extended to S Corporations for the first three years after their change from C Corporation status. Two S Corporation level taxes are now applicable.
to S Corporations with a prior C history; Section 1374 allows a tax on long-term capital gains which can only be applied in the first three years of the S election by a prior C Corporation, and Section 1375 placed a special tax on excessive passive investment income which applies to S Corporations with undistributed earnings and profits accumulated in prior C years.

Another group of changes under DRA affects the qualification for and termination of the S election. The transition rules affecting terminations stated in SSRA of 1982 were modified by DRA of 1984; now, corporations are permitted to elect the general effective date and terminate the election for years beginning after 1981. Revocations, as well as terminations, of the S election can use the waiver of the five-year waiting period for making a new S election as set out in SSRA of 1982.

The third group of changes made by DRA of 1984 relates to the income, deduction and credit items of the S Corporation. An S Corporation's net deductions and debts to its shareholders was the fourth group of changes made by DRA. The "at risk rules as limitations on deductions and on the investment credit" also were changed by the 1984 Act. Other miscellaneous provisions affecting S Corporations and shareholders were modified by the Deficit Reduction Act of 1984.

II. REQUIREMENTS OF S CORPORATION STATUS

A. QUALIFICATIONS/ELIGIBILITY
In order to qualify for S Corporation status and be there­
for exempt from paying taxes on its income, a corporation
must be a "small business corporation" that meets the follow­
ing four conditions: 1) it does NOT have more than thirty­
five shareholders; 2) it does NOT have as a shareholder a per­
son who is not an individual, estate or certain trust; 3) it
does NOT have a nonresident alien as a shareholder; and 4)
it does NOT have more than one class of stock. Section 1361
defines a "small business corporation" as a domestic corpora­
tion which is not an ineligible corporation and which does
not have any of the four above characteristics. The term does
not refer to the financial condition of the corporation, but
rather to the number of shareholders it may have.

The following are considered ineligible corporations, and
therefore, they cannot qualify as S Corporations. Affiliated
corporations may not elect S Corporation status. To be clas­
sified as affiliated, the electing corporation must own 80 per­
cent or more of the stock of another corporation. If the cor­
poration has established inactive affiliates(i.e., affiliated
corporations which do not engage in business or produce taxable
income), the affiliated corporation limitation does not apply.
Financial institutions are also considered ineligible corpora­
tions if these institutions are allowed a deduction for bad
debts under Section 585 or 593 of the Code. An insurance
company is an ineligible corporation if it is taxable under
Subchapter L of the Code; certain casualty insurance companies
are the exception to this. A S Corporation may no longer hold
a foreign subsidiary or a Domestic International Sales Corporation (DISC) unless the S Corporation held the foreign subsidiary or DISC on September 28, 1982. If the exception is the case, the corporation can retain its Subchapter S status as long as its election does not terminate and a majority of its stock is not transferred for reasons other than death. One final type of corporation for which the S election is not available is a corporation electing Puerto Rico and Possessions Tax Credit under Section 936.16.

Further analysis is necessary to determine eligible shareholders which must fall within the maximum limit of thirty-five (SSRA changed the maximum number of shareholders in an S Corporation from twenty-five to thirty-five). A husband and wife (and their estates) are treated as one shareholder when computing the number of qualified shareholders. Eligibility is restricted to individuals, estates and certain trusts. Foreign trusts are now expressly excluded. The determining factor of whether trusts are qualified as S Corporation shareholders is beneficial ownership rather than ownership of record. The area of the kinds of trusts that qualify as shareholders in an S Corporation is a complex one.

Eligible trusts are limited to:17

1) Trusts in which either the grantor (grantor trust) or individual other than the grantor (Section 678 trust) is treated as the complete owner of the trust. ... the deemed owner is considered to be the shareholder. The trust is permitted to continue as a shareholder for 60 days after the deemed owner's death, or for two years after the deemed owner's death if the entire corpus of the trust is included in the deemed owner's estate.

2) Trusts to which stock is transferred under
the terms of a will, provided that within sixty days of such transfer the trust divests itself of the stock.

3) Trusts created primarily to exercise the voting power of the stock. In determining whether the limitation on the number of qualifying shareholders has been exceeded, each beneficiary of the trust is treated as a separate shareholder; in other words, the trust veil is pierced to determine the number of shareholders.

4) A "qualified Subchapter S trust may be a shareholder for tax years beginning after 1981. The individual beneficiary must elect to be treated as the owner of the trust. The election is irrevocable and the trust ceases to be a Subchapter S trust. The election may apply retroactively for a period of no more than two months and fifteen days.

A qualified Subchapter S trust (QSST) is a trust that owns stock in one or more S Corporations, has as its sole beneficiary a U.S. citizen or resident and has specific trust terms. The terms state that there should be only one income beneficiary during the life of the current beneficiary, and corpus distributed during the trust term will be distributed to the current beneficiary, the current beneficiary's interest in the income ends on the earlier of the termination date of the trust or the income beneficiary's death and when the trust terminates during the life of the income beneficiary, all corpus and income must be distributed to that beneficiary. Marital deduction trusts in which the surviving spouse is to receive trust income for the rest of his/her life along with trust principal deductions that are required for the maintenance, comfort and welfare as determined by the trustee's discretion will qualify as an S Corporation shareholder since it satisfies the requirements for trusts stated above.
The fourth condition that must be met before a small business corporation qualifies as an S Corporation is that the corporation cannot have more than one class of stock. Much controversy has arisen concerning what constitutes different classes of stock. A corporation authorized to issue different classes of stock is not prohibited from making an S election if only one class of stock is issued and outstanding. Difference in voting rights also will not violate the one class of stock rule. Several Internal Revenue Service rulings have led to a refined interpretation of the law; "...as long as rights to dividends and rights on liquidation are the same for all shares of stock, the IRS seems to be liberal in permitting other restrictions to be imposed without a second class of stock having been created."20

Additionally, a debt instrument that is classified as straight debt will not be treated as a second class of stock. Section 1362 creates what is called a "safe harbor" for debt that is considered straight debt by meeting the following criteria: a written unconditional promise to pay on demand or on a specified date a certain sum in money if 1) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion or similar factors, 2) there is no direct or indirect convertibility to stock, and 3) the creditor is a person, estate or trust eligible to hold S Corporation stock. According to the Senate Finance Committee, matching the interest rate to the prime rate or some other similar factor will not remove the debt from the safe harbor boundaries.21
B. ELECTION

Once a corporation has determined that it desires S Corporation status and has met all of the necessary eligibility requirements, it must file Form 2553 on a timely basis to make the election. All shareholders must consent to the election. The IRS has a strict position when it comes to late filings of S Corporation election. According to Section 1362, the S election must be made at any time during the preceding year, or at least by the fifteenth day of the third month of the current taxable year. Taxpayers are not allowed "9100 relief" when an S election is filed late. "9100 relief" allows taxpayers to request that a late-filed election be considered timely. The relief provision is permitted when the due date for the election is fixed by Regulations. The S election due date is fixed by the Code; therefore, the IRS doesn't feel that they have the authority to extend the time for filing an S election. An S election can also be lost if it is made prematurely.22 The timing of the S election under SSRA differs from prior law. Before SSRA, the election was required to be made in the preceding tax year or on or before the first seventy-five days of the tax year.

When to make the S election is an important business decision. It should be made only after careful evaluation of all the considerations affecting the corporation are taken into account. If heavy start-up losses are anticipated or if a C Corporation is expecting a period of heavy losses, S Corpo-
ration status should be considered because such losses pass through to shareholders and offset their other income. If shareholders are in lower individual tax brackets than the corresponding corporate rates, the company should opt for S status resulting in larger after-tax profits available to the owners. When a new corporation is formed to hold primarily investment assets, the election of S Corporation status is the route to go since there is no personal holding company tax. An S Corporation can also be used when there is a desire to shift income to lower bracket family members through the use of the family business. Lastly, an S Corporation may be used as an estate planning tool to take the business out of the estate and obtain the benefits of the yearly gift exclusion.23

C. REVOCATION/TERMINATION

Effective with the Subchapter S Revision Act of 1982, corporations may voluntarily terminate their S election if shareholders holding more than one half of the outstanding stock consent to the revocation. Before SSRA, all shareholders were required to agree to the revocation. Presently, a new shareholder with a 50 percent or less interest in the corporation can no longer terminate the election singlehandedly. Previously, a new shareholder had the power to terminate the election by filing an affirmative refusal to consent within sixty days after he or she acquired the stock. The timing of the revocation is also important and changes were enacted
with SSRA of 1982. In general, a revocation must be filed on or before the fifteenth day of the third month of the taxable year to be effective for the first day of the taxable year. If a revocation is filed after the fifteenth day of the third month of the taxable year, it is effective on the first day of the following taxable year. There is an exception to both of the above filing possibilities; a prospective effective date may be specified after the date of the revocation. Under prior law, revocation is effective for the full taxable year if filed before the end of the first month of the taxable year; otherwise, the revocation is effective for the following taxable year. An additional provision of SSRA that was not allowed under prior law is the voluntary termination of an S Corporation in its first tax year. SSRA is silent as to this matter; therefore, the Act of 1982 is interpreted as permitting such a voluntary termination. The only stipulation is that the revocation is filed within the first 2½ months of the beginning of the taxable year or that the prospective date stated is within the tax year indicated on the consent. 24

To file a revocation, the corporation must file a statement stating that it revokes its election made under Section 1362. It must be signed by a person who is authorized to sign the corporate tax return. The revocation must then be filed with the service center in which the S election was filed. The statement must include a list of the number of shares of stock issued and outstanding at the revocation date and the effective date of the revocation. Attached to the revocation statement must be a statement of consent signed by each shareholder consenting to the revocation and the number of shares
An election is terminated when an S Corporation fails to qualify as an S Corporation. That is, the permitted number of shareholders is exceeded, there is a transfer of stock to a corporation, partnership, ineligible trust or nonresident alien, another class of stock other than voting and nonvoting common stock is created or an active subsidiary is acquired. The termination is generally effective on the date the disqualifying event occurred. Prior law was more harsh with regards to the effective date of termination; the termination was retroactive to the first day of the taxable year, and regular corporation status was considered to be for the full year. Under the Subchapter S Revision Act of 1982, two short taxable years result in the year that a termination occurs—one as an S Corporation and one as a C Corporation. All income, expense and similar items are allocated to the two short taxable years pro rata on a daily basis. The shareholders may consent to have normal accounting policies apply to the two short years as an alternative.

Under prior law an S Corporation could obtain no relief from an inadvertent termination. Currently, if the S Corporation corrects the problem that caused the inadvertent termination within a reasonable time and both the corporation and shareholders consent, the business may continue as an S Corporation after the IRS determines that termination was inadvertent. Special rules apply to an S Corporation whose passive income is in excess of 25 percent of gross receipts to avoid
losing its S election. However, the S election is terminated if the 25 percent passive income limit is exceeded for three consecutive years. A previously-terminated S Corporation election may be reelected without IRS permission after five years have passed since the termination. SSRA has repealed the five-year waiting period for those S Corporations whose elections were terminated under prior law restrictions which have been eliminated or eased by the new law, such as the passive income test of 20 percent, the foreign income test in excess of 80 percent and the number of shareholders between twenty-six and thirty-five. 28

An interesting point brought up by Bravenec and Gray in their article, "Shareholder Agreements Can Preserve the S Election and Remedy Its Termination," is that agreements between S Corporations and their shareholders may be used to protect against S election termination and to provide for those harmed by the S Corporation termination. An S election is relatively easy to terminate, either deliberately or inadvertently; therefore, a shareholder agreement should be drawn up to prevent any type of termination except those terminations agreed upon by over a majority of the shareholders. The authors suggest, "At a minimum, the agreement should require that the person contemplating a transfer to an eligible shareholder (or other person) notify the corporation and the other shareholders, who then have the right of first refusal to purchase the shares...." 29 The right of first refusal should help to prevent an ineligible shareholder from obtaining the S Corpora-
tion stock in a transfer because the notice and offer made to the other shareholders should contain the identification of the transferee. The right of first refusal does not have to be limited to the transfer of stock to an ineligible shareholder; more often found is the practice of prohibiting the transfer of corporate stock to any third party, except in a few cases where the transfer is to be made to a family member or eligible trusts.

The shareholders' agreement could also be drawn up to provide that any transfer of stock to an ineligible shareholder is ineffective and that the title of the shares will automatically remain with the corporation upon the transfer attempt or first refusal offer. State laws should be considered if this type of an agreement is proposed because certain states do not permit this type of agreement. All stock certificates should contain a legend which summarizes all such restrictions which might be placed on the stock.

If the above-mentioned mechanisms somehow still permit an ineligible shareholder to hold S Corporation stock and thus, causing a termination of the S status, the shareholders' agreement should provide for liquidation damages for affected shareholders. This provision will also help to provide an incentive to all shareholders to take steps to prevent a termination of S status. These precautions should be considered in the writing of wills and trust arrangements. The agreement should provide that the person(or entity) responsible for the termination is liable for damages, regardless of fault or other circumstances.
This provision is desirable because it requires minimal planning to avoid an ineligible shareholder termination. The factors to be used for determining damages should be set forth in the shareholder agreement. If an S Corporation was set up to allow the losses of the company to flow through to the shareholders, damages should include the unavailable net deductions that would have been allowed and any possible loss recovery that might be taxed to the shareholder. If the S Corporation is a mature corporation with substantial earnings to be passed through to the shareholders, both the shareholders and the corporation are aggrieved parties. Total damages should be limited to a five-year period unless the responsible party can demonstrate that at the time of the damages, a shorter period or a different measure of future income is more appropriate. 31

III. OPERATION OF S CORPORATIONS.

A. CHOICE OF TAXABLE YEAR

Before the Subchapter S Revision Act of 1982 was enacted, the Internal Revenue Code did not specifically govern the selection of a taxable year for Subchapter S Corporations. The lack of any provision allowed shareholders a deferral privilege that was not available to proprietors or partners. A calendar-year shareholder in a Subchapter S Corporation with a taxable year ending on January 31 could defer any income earned from the corporation in February to December as long as that income was not distributed to him/her. This income would not be reported as taxable income until the following year. Under prior
law, a Subchapter S Corporation was allowed considerable flexibility in its initial year when electing a fiscal year. In response to this very advantageous deferral being used by many shareholders, Treasury officials decided to take some action after they learned that financial advisers were suggesting that clients form Subchapter S Corporations in an effort to defer tax liability.

Upon the recommendation of the Treasury officials, SSRA included a provision requiring S Corporations to use a "permitted year" (one ending on December 31) or "any other accounting period for which the corporation establishes a business purpose...." In determining whether a tax year other than a calendar year is suitable, the Internal Revenue Service, when reviewing the tax returns, should turn to the partnership rules, i.e., the deferral of income is less than or equal to three months. For a corporation to be eligible to select a taxable year other than a calendar year, it must show a business purpose for the different accounting period. The business purpose is substantiated by a specific annual business cycle or an ability to show that income would be substantially distorted under a calendar-year basis. SSRA with its new restriction in the selection of a taxable year in effect, placed most S Corporations on the same tax year as that of their shareholders.

A transitional rule for S Corporations that had already elected the S status under prior law and had a fiscal year other than the calendar year was also set forth in SSRA. It stated that those corporations affected could continue to keep
their S Corporation status and the old fiscal year as long as 50 percent or more of the outstanding stock in such corporation determined on the effective date of SSRA continues to be owned by the same shareholders. Changes in ownership did not include gifts and bequests. 35

Those corporations that wish to have a fiscal year other than a calendar year should turn to Section 4.04 of Rev. Proc-83-25. This section provides that the requirement of the permitted year is satisfied if the taxable year coincides with the corporation's natural business year. This happens if the corporation's gross receipts for the last two months of the twelve-month period ending with the last month of the requested natural business year, and for the last two months for each of the two preceding twelve-month periods, are equal to or are greater than 25 percent of total gross receipts. If there are two or more two-month periods that both meet the 25 percent test, the natural business year is deemed to end with the period that has the highest average percentage of gross receipts for the three preceding years. The natural business year-end should be the most useful for seasonal businesses. The use of Rev. Proc. 83-25 is limited to one time. Also, the selection of the first year must be made within the permitted time of the S election, which is in advance or at the latest, 2½ months after the beginning of the first year for which an S election is desired. 36

B. DISTRIBUTIONS TO SHAREHOLDERS
There are three types of distribution from S Corporations that can be made to shareholders: cash distributions, property distributions and distributions of appreciated property. Currently, cash and property distributions are treated in the same manner; distributions of appreciated property require special treatment. A further classification can be made to aid analysis of how to account for distributions of cash and property by separating corporations with accumulated earnings and profits from those who are without accumulated earnings and profits.

Cash and property distributions from corporations without accumulated earnings and profits apply first to reduce the basis held in stock. Any excess is treated as capital gains. Under prior law (before SSRA), distributions from current earnings and profits were taxable to shareholders in the year received. 37

Distributions from corporations with accumulated earnings and profits are applied first to the accumulated adjustments account (AAA) which holds net income items not distributed previously for the S Corporation period. Before SSRA, distributions of undistributed taxable income (UTI) or previously taxed income (PTI) were not taxable to the shareholders. Any excess distributions are currently taxed as dividends to the extent of accumulated earnings and profits, whereas previously these excess distributions were taxed as dividends if the corporation had excess current earnings and profits or accumulated earnings and profits. Any remaining balance reduces basis in
stock and any excess over basis is treated as a gain from sale or exchange under current law.\textsuperscript{38}

Distributions of appreciated property result in a gain to be recognized by the S Corporation as if the appreciated property had been sold at its fair market value. The gain recognition on the distribution will pass through to the shareholders, and it will retain its character. If the property is depreciable property, the gain might be converted to ordinary income under Section 1239. Under the old laws governing S Corporations, no gain was recognized to Subchapter S Corporations except under Section 311.\textsuperscript{39}

C. SHAREHOLDER BASIS AND NET OPERATING LOSSES

A shareholder's basis is increased for income items, including nontaxable income and excess depletion along with additional stock purchases and capital contributions. Decreases in stock basis are made for distributions not includable in the shareholders' income, loss and deduction items, certain expenses and oil and gas well depletion. The basis of the stock cannot be reduced below zero. Any excess deductions over stock basis are applied to reduce the basis of shareholder loans to the corporation; these deductions applied to the loans cannot go below zero either. A shareholder's basis in indebtedness must be restored to the extent of any previous deductions before the shareholder's basis in stock may be increased.\textsuperscript{40}

Before SSRA was enacted, a net operating loss was deducti-
ble to the extent of the sum of his or her adjusted stock basis and loans to the corporation. Any excess losses were lost and not available as a carryover. The same rules apply now except that the shareholder is allowed to carry forward excess net operating losses indefinitely. Special rules limit the carryover of net operating losses in the termination year.41

D. FRINGE BENEFIT RULES

A C Corporation is allowed to provide certain fringe benefits to its employees. The cost is deductible by the corporation, but it is not reportable as income by the employee. Prior to SSRA, S Corporations were also allowed this favorable treatment for fringe benefits. Such benefits include $50,000 worth of group-term life insurance, qualifying accident and health plans and certain medical plans, meals and lodging furnished for the convenience of the employer and death benefits of up to $5,000 paid to a deceased employee's beneficiary. An S Corporation is still allowed these deductions, and the cost will not be reportable in income by the employee unless the benefits are paid to employee-shareholders who own more than 2 percent of the S Corporation's stock.42

E. TAX TREATMENT OF S CORPORATIONS

The decision to elect S Corporations status may be an easy one for federal income tax purposes, but the effects of state taxation must also be considered. Some states do not recognize
the S status; in these states, "...corporations are subject to the state corporate income tax and distributions are usually subject to the state personal income tax when actually received." See Exhibit 1 for a summary of which states do and do not recognize the S Corporation status.

The Subchapter S Revision Act of 1982 significantly changed many of the laws pertaining to the taxation of S Corporations. Exhibit 2 highlights the major differences. After 1982, Subchapter S taxable income or loss is generally determined according to the tax rules applicable to partnerships, except that amortization of organization expenditures is an allowable deduction. Although an S Corporation is generally not a taxable entity, Section 1363 requires that Subchapter S taxable income be separately computed.

IV. ADDITIONAL CONSIDERATIONS FOR THE S CORPORATION

A. AUDITS OF S CORPORATIONS

An interesting sidelight to this analysis of S Corporations is the consideration of important elements in auditing an S Corporation. An auditor should determine that an S Corporation has met all the requirements of S status and that the requirements are being maintained. In addition, the practitioner should be assured that no S Corporation penalty taxes apply. It is important that these objectives are satisfied because otherwise, misleading financial statements might result. Exhibit 3 contains a list of questions that take into account
the major changes made by SSRA of 1982 and would be useful in auditing an S Corporation. 45

B. ADMINISTRATIVE AND JUDICIAL PROCEEDINGS

Before SSRA, when issues were raised regarding S Corporation income and deductions, they were determined in administrative and judicial proceedings between the IRS and the individual shareholder whose tax liability was affected. Under the Act of 1982, all such proceedings will be conducted at the corporate level in a unified proceeding. An S Corporation shareholder is required under SSRA to file tax returns that treat every Subchapter S item consistently with the manner in which it was treated on the corporate tax return unless the shareholder notifies the IRS of any inconsistencies. 46

Subchapter S Corporations were originally devised to allow small business corporations the advantages of operating as a corporation with the benefits of taxation as a partnership. The Subchapter S Revision Act of 1982 drastically changed many of the provisions originally found in prior law. The Act greatly simplified the law that previously ruled; this was its major goal. As a result of SSRA, S Corporations have become a more useful form of ownership. Business owners/taxpayers should re-examine their current operations and needs to determine if they can be met by electing S Corporation status.
Exhibit 1

State recognition of subchapter S status

<table>
<thead>
<tr>
<th>State</th>
<th>Recognize subchapter S status</th>
<th>State</th>
<th>Recognize subchapter S status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Yes-1</td>
<td>Minnesota</td>
<td>Yes</td>
</tr>
<tr>
<td>Alaska</td>
<td>Yes</td>
<td>Mississippi</td>
<td>Yes</td>
</tr>
<tr>
<td>Arizona</td>
<td>Yes</td>
<td>Missouri</td>
<td>Yes-4</td>
</tr>
<tr>
<td>Arkansas</td>
<td>Yes</td>
<td>Montana</td>
<td>Yes</td>
</tr>
<tr>
<td>California</td>
<td>No</td>
<td>Nebraska</td>
<td>Yes</td>
</tr>
<tr>
<td>Colorado</td>
<td>Yes</td>
<td>New Hampshire</td>
<td>No</td>
</tr>
<tr>
<td>Connecticut</td>
<td>No</td>
<td>New Jersey</td>
<td>No-4</td>
</tr>
<tr>
<td>Delaware</td>
<td>Yes</td>
<td>New Mexico</td>
<td>Yes</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>Yes-2</td>
<td>New York</td>
<td>Yes</td>
</tr>
<tr>
<td>Florida</td>
<td>Yes-3</td>
<td>North Carolina</td>
<td>No</td>
</tr>
<tr>
<td>Georgia</td>
<td>Yes</td>
<td>North Dakota</td>
<td>Yes</td>
</tr>
<tr>
<td>Hawaii</td>
<td>Yes</td>
<td>Ohio</td>
<td>No</td>
</tr>
<tr>
<td>Idaho</td>
<td>Yes</td>
<td>Oklahoma</td>
<td>Yes</td>
</tr>
<tr>
<td>Illinois</td>
<td>Yes</td>
<td>Oregon</td>
<td>Yes</td>
</tr>
<tr>
<td>Indiana</td>
<td>Yes</td>
<td>Pennsylvania</td>
<td>Yes</td>
</tr>
<tr>
<td>Iowa</td>
<td>Yes</td>
<td>Rhode Island</td>
<td>Yes</td>
</tr>
<tr>
<td>Kansas</td>
<td>Yes</td>
<td>South Carolina</td>
<td>No</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Yes</td>
<td>Tennessee</td>
<td>No</td>
</tr>
<tr>
<td>Louisiana</td>
<td>No-4</td>
<td>Utah</td>
<td>Yes</td>
</tr>
<tr>
<td>Maine</td>
<td>Yes</td>
<td>Vermont</td>
<td>Yes</td>
</tr>
<tr>
<td>Maryland</td>
<td>Yes</td>
<td>Virginia</td>
<td>Yes</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>No</td>
<td>West Virginia</td>
<td>Yes</td>
</tr>
<tr>
<td>Michigan</td>
<td>No-4</td>
<td>Wisconsin</td>
<td>Yes</td>
</tr>
</tbody>
</table>

1-Subchapter S status recognized for tax years beginning after 1984.

2-But only if the corporation has gross income under $12,000.

3-No personal income tax levied.

4-Subchapter S status recognized, in effect, for individuals but corporation remains taxable.

## Significant Changes in Taxation of S Corporations

<table>
<thead>
<tr>
<th><strong>Old Law</strong></th>
<th><strong>New Law</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The maximum number of shareholders is 25.</td>
<td>The maximum number of shareholders is 35.</td>
</tr>
<tr>
<td>2. Only one class of voting common stock may be issued.</td>
<td>Both voting and nonvoting common stock may be issued.</td>
</tr>
<tr>
<td>3. The Subchapter S election is terminated if more than 20% of the corporation's gross receipts is from &quot;passive investment income&quot; (e.g., interest, rents, dividends).</td>
<td>&quot;Passive investment income&quot; test is repealed, unless the corporation has accumulated earnings and profits from prior years in which case the election is terminated only if the corporation's passive investment income is more than 25% of gross receipts for three consecutive year.</td>
</tr>
<tr>
<td>4. The Subchapter S election is terminated if more than 80% of the corporation's gross receipts is from foreign income.</td>
<td>Foreign-source gross receipts test repealed.</td>
</tr>
<tr>
<td>5. Subchapter S status is automatically terminated if a new shareholder refuses to consent to the election.</td>
<td>New shareholders are bound by initial election.</td>
</tr>
<tr>
<td>6. All shareholders must consent to a revocation of Subchapter S election.</td>
<td>Shareholders owning a total of more than 50% of the voting stock may revoke a Subchapter S election.</td>
</tr>
<tr>
<td>7. The Corporation's net taxable income or loss is passed through to the shareholders; however, the character of items of income, deductions and loss, other than credits and long-term capital gains, are not passed through to the shareholders.</td>
<td>Analogous to partnerships, items of income, deduction, loss and credit retain their original character when passed through to the shareholders.</td>
</tr>
</tbody>
</table>
Exhibit 2, page 2

<table>
<thead>
<tr>
<th><strong>Old Law</strong></th>
<th><strong>New Law</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>8. A Subchapter S Corporation may select either a calendar or fiscal year as its tax year.</td>
<td>A Subchapter S Corporation must generally have a calendar year for tax purposes unless it can establish a valid business purpose for having a fiscal year.</td>
</tr>
<tr>
<td>9. A shareholder may deduct his allocable net loss only to the extent of his adjusted basis in his stock plus the amount of loans made to the corporation. Any excess loss may not be carried forward and is lost forever.</td>
<td>A shareholder's allocable net loss in excess of his adjusted basis in the stock and loans to the corporation may be carried forward to, and deducted in, any future tax year in which the shareholder's basis in his stock plus loans is at least equal to the loss.</td>
</tr>
<tr>
<td>10. The taxable status of Subchapter S distributions to shareholders is dependent on various factors, such as the taxable income or loss of the corporation, the current and accumulated earnings and profits of the corporation and the timing of the distributions.</td>
<td>Analagous to partnerships, distributions will generally decrease a shareholder's adjusted basis in his stock and will therefore generally be non-taxable.</td>
</tr>
<tr>
<td>11. The special treatment of employee fringe benefits such as the 35,000 death benefit exclusion, premiums and benefits of accident and health plans, group-term life insurance and certain meals and lodging is applicable to shareholder-employees.</td>
<td>The special treatment of certain employee fringe benefits is not applicable to shareholder-employee owning more than 2% of the firm's stock.</td>
</tr>
</tbody>
</table>
Exhibit 3

Questions Useful in Auditing S Corporations

1. Has Form 2553 been filed and have all shareholder consent statements been signed?

2. Is the corporation a domestic corporation?

3. Does the corporation consist of no more than 35 shareholders?

4. Has it been determined that only individuals, estates and certain trusts are corporation shareholders?

5. Does the corporation have only one class of stock?

6. Has it been determined that no nonresident aliens are corporation shareholders?

7. Does the corporation own less than 80 percent of stock of an active subsidiary?

8. Has it been determined that the corporation is not a domestic international sales corporation (DISC) or former DISC?

9. Has it been determined that the corporation is not an insurance company taxed under subchapter L?

10. Has it been determined that the corporation is not a financial institution taxed under sections 585 or 593 of the IRC?

11. Has it been determined that section 936 (relating to tax credits for taxpayers doing business in Puerto Rico and U.S. possessions) does not apply to the corporation?

12. Has form 1120S been filed with the Internal Revenue Service by the 15th day of the third month after the end of the corporation's tax year?

13. Has it been determined from the will of shareholders that the distribution of stock from a deceased shareholder's estate does not result in more than 35 shareholders?

14. Does the corporation have any passive investment income? If so, will tax planning help to avoid the penalty tax on passive investment income?

15. Is the corporation vulnerable to a penalty tax on net capital gains? If so, will tax planning help to avoid this penalty tax?
16. Has it been determined that the S corporation's election has not been inadvertently terminated by having more than 25 percent of its gross receipts from passive investment income for its gross receipts from passive investment income for three consecutive years?

17. As an additional client service, has it been shown that the corporation's shareholders would benefit from the use of a noncalendar year? If so, has approval for adopting, retaining or changing to a noncalendar year been obtained from the IRS?

18. As an additional client service, has it been shown that changes in the level of corporate or shareholder income, or both, might make it advisable to revoke or terminate the election?

19. As an additional client service, had IRS approval been requested for an inadvertent termination of the election?

20. As an additional client service, has it been determined that net operating losses from years in which the S corporation was a C corporation are about to expire? If so, does that expiration make it advisable to revoke or terminate the election?
ENDNOTES


6 "Small Business Study Cites Problems in 33% Flat Corporate Rate Proposal," p.24.


11 Murphy, p.161.


17. McKeen, pp. 24, 25.


25. McKeen, p. 4-3.

26. Rosenberg, p. 94.


28. Murphy, p. 164.


30. Bravenec, Lorence L. and David W. Gray, p. 130.

31. Bravenec, Lorence L. and David W. Gray, pp. 130-133.


35Jamison, p. 558.


BIBLIOGRAPHY


