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free himself from the burdensome family attribution rule. Costly Trap No. 4 is the widespread but inaccurate assumption that only taxpayers who are motivated by tax larceny get tagged with ordinary dividend treatment on stock redemptions. And Costly Trap No. 5 is the erroneous belief that the unfavorable general rule cannot apply when stock is sold to a subsidiary or brother corporation.

III

HOW TO USE SUBCHAPTER S AND SECTION 1244 WITHOUT RUNNING INTO TROUBLE

Hugh Calkins*

Subchapter S and section 1244 were enacted in 1958 as part of a legislative program designed to aid small business enterprises. There is a growing body of commentary on each of these provisions, much of it critical. This article has a more friendly thesis: that because in many situations commonly encountered in general corporate practice these sections may be used safely and simply, they should be popular instruments of tax planning. Perfect they may not be; useful they certainly are.

To support this thesis it is neither necessary nor wise to chart the frontiers of the usefulness of the new sections. This article describes only the solid ground, where general practitioners can walk with confidence.

SECTION 1244

Section 1244, entitled “Losses on Small Business Stock,” is far simpler than Subchapter S. Digesting it will serve as an aperitif for the main course to follow.

Section 1244 is a one-way street which frequently can benefit and never can hurt an individual taxpayer. Where it is applicable, a loss realized by an original, individual investor on the sale, exchange, or loss

* The author gratefully acknowledges the assistance of Gerald Witherspoon, a member of the Ohio Bar, in preparation of this article.
2. E.g., BNA, TAX MANAGEMENT PORTFOLIO NO. 60, SUBCHAPTER S — ELECTIONS AND OPERATIONS; Moore & Sohlien, Adventures in Subchapter S and Section 1244, 14 TAX L. REV. 453 (1959); Murdoch, Effect of Subchapter S on Decisions as to Form of Business Organization, 38 TAXES 19 (1960); Nicholson, Section 1244 Stock, 38 TAXES 303 (1960); Wright, Utilization of Subchapter S and Section 1244 Stock, 12 W. RES. L. REV. 225 (1961).
of value of the common shares of a small business corporation is taxable as an ordinary rather than a capital loss. This portion of the article will consider (A) the circumstances under which section 1244 is available, (B) the procedure to be followed when issuing shares so that they qualify under section 1244, (C) the consequences of qualifying, and (D) some implications for tax and investment planning.

When Section 1244 Is Available

In order that securities qualify as "section 1244 stock" entitled to the ordinary loss benefits of the statute, five circumstances not necessarily within the control of the tax planner must be present.

The Corporation Must Be a "Small Business" at the Time a Plan To Issue the Section 1244 Stock Is Adopted

Two tests must be met to qualify under this requirement. First, the equity capital of the corporation at the time of adoption of the plan plus the amount which may be received for stock offered under the plan must not exceed $1,000,000. For purposes of this test, equity capital is the sum of the corporation's money and other property less the amount of its indebtedness to creditors other than shareholders. Property is taken into account in this calculation at its book value for tax purposes.3 Second, the equity investment in the corporation since June 30, 1958, plus the amount which may be received for stock offered under the plan, must not exceed $500,000. For purposes of this test, "equity investment" is the aggregate amount of money and other property which the corporation has received for stock, either as a contribution to capital or as paid-in surplus.4 Earned surplus is not considered.

No Other Offering of Stock May Be in Force When the Plan Is Adopted or When Section 1244 Stock Is Issued

A corporation which has outstanding convertible securities or a stock option plan, for example, cannot issue section 1244 stock.5 A prior offer is considered to be outstanding until all the shares offered are issued or the plan is withdrawn by affirmative action of the corporation.6

Only Common Stock May Be Issued Under the Plan

Although either voting or non-voting stock may qualify under section 1244, neither securities convertible into common stock nor common stock

3. CODE § 1244(c) (2) (B).
4. CODE § 1244(c) (2) (A).
6. Ibid.
convertible into other securities will be treated as common stock. This requirement does not prohibit the issuing corporation from having two or more classes of stock outstanding when the plan is adopted or when section 1244 stock is issued. This appears to be true — although argument on this point may be possible — even though a class of preferred stock is issued immediately prior to adoption of the plan.

The Consideration for Which Section 1244 Stock Is Issued Must Be Cash or Property Other Than Stock or Securities

Thus, section 1244 stock may not be issued in exchange for the services of a promoter, for technical services, upon conversion of a debt security, or pursuant to an employee stock option. Moreover, stock received for other securities in most reorganizations does not qualify.

At the Time the Loss Is Incurred, More Than 50% of the Corporation's Aggregate Gross Receipts in a Preceding Period of Not More Than Five Taxable Years Must Be "Active Business" Income

Royalties, rents, dividends, interest, and gains from sales or exchanges of stock or securities are included in the disqualifying types of income. For purposes of calculating the quantity of qualifying or disqualifying types of income, "gross receipts" are not reduced by returns and allowances, costs, or deductions. Receipts from sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. In addition, the Regulations add a more general test to the arithmetic one: the corporation must be "largely an operating company." The validity of this requirement is uncertain.

All but the last of these five circumstances need be present only at the time the section 1244 plan is adopted or stock is issued. For example, a corporation which was small at the time of adopting a plan to issue stock may grow beyond the $1,000,000 equity capital limit before the shares actually are issued without becoming disqualified under section 1244; and common shares duly issued under a section 1244 plan do not

8. Under CODE § 1244(d) (2), however, substituted stock is acceptable if it is received in exchange for stock pursuant to a reorganization described in CODE § 368(a) (1) (E) or CODE § 368(a) (10) (E). See Reg. § 1.1244(d)-3(a) (1960). Moreover, common stock received as a taxable stock dividend made with respect to shares of § 1244 stock is acceptable under the statute. See Reg. § 1.1244(d)-3(b) (1) (1960).
9. CODE § 1244(c) (1) (E).
11. See Reg. § 1.1244(c)-1(g) (2) (1960), as amended, T.D. 6637, 1963-1 CUM. BULL. 139. There is some basis for the requirement in congressional history. See excerpt from Senate summary, 104 CONG. REC. 17090 (1958), quoted in 4 CCH 1959 STAND. FED. TAX REP. ¶ 4770.11.
lose section 1244 status when preferred shares are issued subsequently under a different plan.

**Procedure Required To Be Followed**

A small business corporation issuing solely common stock for cash or property, having no other stock-issuing plan in effect, and anticipating predominantly active business receipts can obtain section 1244 status for the original investor in the new shares by following the procedure prescribed by the Regulations at the time the stock is issued. The Regulations often appear more petty than necessary: i-dotting and t-crossing is the order of the day. Since the procedure spelled out in the Regulations is more detailed than the Code requires, taxpayers who have failed to comply with the Regulations should consider challenging their validity.

Nevertheless, compliance with the Regulations is not difficult, and to avoid controversy, the prescribed ritual should be strictly observed.

The correct procedure is:

1. Unless the corporation is newly formed or it is otherwise certain that this step is unnecessary, the directors should take action terminating any existing plan for the issuance of stock of any class.
2. The directors or incorporators should adopt a written plan to issue section 1244 stock. The plan should refer to section 1244 and specifically state, in dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued. In addition, the document should be dated and should specifically state the period of time (not more than two years) within which the offer is to remain open. Errors will be avoided if that period is stated to terminate immediately prior to any issuance of stock not pursuant to the plan.

Following the issuance of the shares, the issuing corporation is required to maintain records showing, for example, the persons to whom the stock was issued, the date of issuance to each, the amount and type of consideration received from each, the basis and fair market value of property received in consideration, and the equity capital of the corporation on the date of the adoption of the plan.

**Benefits Available From Section 1244 Status**

**To Whom Available**

The ordinary loss treatment of section 1244 stock is available only to the individual who is the original purchaser from the issuing small

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12. Section 1244(e) authorizes the Secretary or his delegate to "prescribe such regulations as may be necessary to carry out the purposes of this section." Whether this explicit delegation materially enlarges the delegation of authority made generally by CODE § 7805 has not yet been adjudicated.

business corporation. Where a partnership is the original purchaser, a partner at the time the stock is issued qualifies if he remains a member of the partnership and the partnership remains the owner of the shares until the time the loss is incurred. Original investor status cannot be passed on, even to a donee, legatee, or estate, or to a purchaser from an underwriter of the original issue.¹⁴

Benefits

Section 1244 permits the qualified investor to claim his ordinary loss upon any sale, exchange, liquidation, or loss of value of his shares, whether or not all of the shares are disposed of in a single taxable year. The amount of loss which may be claimed is normally the difference between the price paid by the investor for the shares and the price or value, if any, which he receives upon their sale or exchange. A special rule, however, limits the amount of loss which may be claimed on section 1244 stock issued in exchange for property which before the exchange had a basis exceeding its fair market value.¹⁵

The maximum ordinary loss which an individual taxpayer may claim under section 1244 in any single year is $25,000. A husband and wife filing a joint return may claim up to $50,000 in a single year. Where section 1244 stock is held by a partnership, these annual limitations are imposed at the partner level.

A section 1244 loss is a net operating loss. Investors who do not have sufficient income in the year of sale or exchange to absorb their allowable ordinary loss under the provision can carry the excess loss back three years and forward five years against other income. This privilege is not, however, applicable to losses in excess of the applicable annual limitation. Such losses are to be treated as arising from the sale or exchange of a capital asset.¹⁶ Therefore, an investor anticipating losses in excess of his annual limitation should attempt to space the sale or exchange of his shares over several taxable years.

Some Implications for Tax and Investment Planning

Prior to enactment of section 1244, it was standard tax planning practice for an investor in a corporation which he and his friends controlled to accompany a reasonable investment in stock with a loan for as much of his total investment as thin capitalization considerations would allow. If the corporation prospered, earnings might be recovered without dividend tax to the extent of the loan; if it failed, the investor was

¹⁴ See CODE § 1244(d) (4); Reg. § 1.1244(a)-1 (b) (1960).
¹⁵ CODE § 1244(d) (1) (A); Reg. § 1.1244(d)-1 (1960).
¹⁶ Reg. § 1.1244(b)-1 (1) (1960).
no worse off, and if he could claim "professional investor" status he might be better off to the extent of the debt portion of the investment.

Section 1244 has changed the equation. The confident investor still may use debt to limit the double tax on the recovery of earnings. But a more pessimistic and cautious investor may choose instead to hedge his bet by placing his entire investment in the form of section 1244 stock so as to assure an ordinary loss deduction if a loss is incurred.

In this respect, section 1244 obtains for investments in small businesses some of the characteristics which investors in the petroleum industry have long enjoyed. The tax leverage afforded by the availability of ordinary losses if the venture fails, and capital gains if the venture prospers, has long supported a substantial flow of investment funds into speculative oil well drilling. If investment firms are as energetic as oil well promoters in encouraging high tax bracket individuals to spread their risks among numerous ventures, and ways are found to assure continuity of management similar to that which has been developed to protect petroleum operators, the intent of Congress that section 1244 should stimulate substantial investment in small business may yet be achieved.

**Subchapter S**

The purpose of Subchapter S is to give individual investors the state law advantages of corporate status, notably limited liability, without the federal tax disadvantage of the corporation — the double tax on distributed earnings. The means employed to achieve this purpose is to permit a corporation to elect to be taxed substantially as a partnership, so that the corporation itself pays no federal tax and its income and losses are reflected directly in the shareholders' returns.

The difficulty with this approach from the point of view of the proponents of a simpler Code is that a Subchapter S corporation is not taxed precisely as a partnership and presents tax disadvantages to its shareholders as well as tax benefits. Adoption of Subchapter S status, unlike section 1244 status, is not a one way street benefiting the taxpayer. Moreover, even where the circumstances are propitious, a Subchapter S corporation cannot be maintained safely without care and supervision which are certain to involve material legal and accounting costs. Subchapter S, therefore, does not make unnecessary a choice between the old instruments of corporate planning, as some might have hoped; it merely creates a third instrument which must be examined.

This author believes that widespread criticism of Subchapter S on the foregoing grounds has obscured the fact that there are situations commonly encountered in general practice where the advantages of Sub-

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chapter S status clearly outweigh its risks and costs. In approaching this proposition, it is well (1) to start with the five circumstances, frequently not within the control of the tax planner, which must be present if Subchapter S is to be available; (2) to consider next the most common situations in which the election of Subchapter S will be desirable; and then (3) to proceed to a statement of four rules which should be kept in mind by every advisor of a Subchapter S corporation. A short discussion of some of the more important peculiarities of Subchapter S status will conclude this article. Those interested in the refinements of Subchapter Smanship should look elsewhere.\textsuperscript{18}

**When Subchapter S Is Available**

Unlike section 1244, Subchapter S imposes no limits upon the financial size of corporations eligible for its benefits. Both giants and pygmies can qualify, so long as five requirements are met. Again unlike section 1244, all these requirements must be met continuously if Subchapter S status is to be maintained.

1. The corporation must not have more than ten shareholders, all of whom must be individuals or estates. Each shareholder must be either a citizen of the United States or an alien resident in this country.

2. Only one class of stock may be outstanding. Should any indebtedness of the corporation to shareholders be treated as stock for tax purposes, this second class of "stock" will disqualify the corporation. Stock option plans, however, are entirely permissible.

3. The enterprise may not be a member of an affiliated group of corporations as defined in section 1504. Having a subsidiary is therefore a disqualifying factor.

4. Eighty per cent or more of the gross receipts of the corporation for each taxable election year must be "active conduct" income. Royalties, rents, dividends, interest, and gains (not offset by losses) from sales or exchanges of stock or securities are included in the disqualifying types of income.\textsuperscript{18} "Gross receipts" for purposes of this requirement are not reduced by returns and allowances, costs, or other deductions, save that, in the case of the sale or exchange of stock, receipts are taken into account only to the extent of gains.

5. The corporation must be incorporated domestically, and no more than 80\% of its gross receipts may come from foreign sources during the year.

\textsuperscript{18} See note 1 supra.

\textsuperscript{19} Receipts from the operation of a hotel, boarding house, tourist home, motor court, motel, or apartment house by a corporation furnishing traditional hotel services do not constitute "rents" under an exception provided in Reg. § 1.1372-4(b) (5) (iv) (1959).
When Subchapter S Is Desirable

There are three common situations in which the election to be taxed under Subchapter S should be made:

Corporations Owned by a Small Group of Shareholders, Some of Whom Are Not Key Employees, Who Do Not Have Substantial Other Income, and Who Desire Some Material Dividend Income From Their Company

The prototype of this situation is the family business, which until 1958 was compelled to choose between limited liability and limited taxation. Subchapter S permits a family business to protect the family from creditors without paying the substantial penalty of double taxation on dividends.

There is a particular reason why Subchapter S is attractive to a family. As will be seen later, the divergent interests of unrelated shareholders are a principal source of the complexities of Subchapter S status. In a family, such differences of interest and opinion occur less often. Moreover, typically some family members are less active than others, and salaries, therefore, are not always an entirely suitable means to transfer earnings to family members.

Newly-formed Corporations Anticipating Start-up Losses or Incurring Heavy Risks and Having a Small Group of Shareholders at Least Some of Whom Have Outside Incomes

The opportunity which Subchapter S gives an electing corporation to pass its net operating losses directly to its shareholders makes the election to be taxed under its provisions a means to attract equity capital to new corporations anticipating start-up losses for one or more years. Under these circumstances, a high-tax-bracket investor may recover much of his investment in tax deductions against his other income. Termination of the election when the corporation becomes profitable will insulate the investor from individual surtax until the point of unreasonable accumulation is reached. Then a capital gain can be achieved through sale.

Established companies needing additional capital in high risk situations also may find Subchapter S useful. While existing companies, far more than new ones, encounter complexities under Subchapter S (as will be seen below), the encounter may be worth the trouble. This is true especially where section 1244 is unavailable, as when the corporation has a stock option plan outstanding. Subchapter S provides an alternative opportunity to investors to realize ordinary losses in the event of the failure of the enterprise. Subchapter S also permits current losses to be taken when realized by the corporation. Moreover, the losses which may
be claimed by the investor in a Subchapter S corporation have no annual
dollar limits; they are limited only by the sum of the shareholder's bases
in the stock and indebtedness of the corporation. So long as both sets of
requirements can be met, therefore, a small business enterprise often can
and should use section 1244 and Subchapter S together.

Corporations Owned by a Small Group of Shareholders,
Even When Some or All Are in High Brackets, Where Distribution
of Most of the Corporate Income Is Planned

A third role for Subchapter S is to operate as a tool to mitigate the
impact of the additional tax on unreasonable accumulations of income. A
corporation compelled by section 531 of the Code to make substantial
distributions to shareholders may find Subchapter S a suitable refuge.

The attractiveness of larger distributions to shareholders in the higher
brackets has been increased, moreover, by the Revenue Act of 1964.
This act provides a maximum rate of 77% during 1964, and a maximum
rate of 70% thereafter. Thus, the maximum effective rates on business
income reflected directly in individual returns are now little higher than
the aggregate of the corporate rate and a capital gains tax on the
balance.\(^\text{20}\)

How Subchapter S Status Is Acquired and Preserved

To acquire and preserve Subchapter S status without unnecessary com-
plexities or adverse consequences, several rules should be observed.

The Election Must Be Proper and Timely

Under the statute, the corporation and each shareholder must make
an election in such manner as the Treasury has prescribed within one
month preceding or one month following the commencement of the
taxable year.\(^\text{21}\) As in the case of section 1244, the Commissioner has

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20. Other situations in which the Subchapter S election is desirable are discussed elsewhere
in the literature. See, e.g., BNA, TAX MANAGEMENT PORTFOLIO No. 60, SUBCHAPTER
S — ELECTIONS AND OPERATIONS; Landis, Advantages and Disadvantages of the Subchapter
S Election, N.Y.U. 18TH INST. ON FED. TAX 723 (1960); Murdoch, Effect of Subchapter S
on Decisions as to Form of Business Organization, 38 TAXES 19 (1960); Valentine, Taxation
of Shareholders of Subchapter S Corporations During the Election Period, N.Y.U. 18TH INST.
ON FED. TAX 689 (1960). For example:

1) Under § 1375 of Subchapter S, net long-term capital gains of an electing corpora-
tion retain their character when taxed to the individual shareholders. Thus a single year
election may be appealing to shareholders of a small corporation which anticipates a sub-
stantial capital gain on the sale that year of capital assets or property used in the trade or
business.

2) Under § 1231 of Subchapter S, net losses on the sale of property used in trade or
business pass through to shareholders of an electing corporation as a contribution to their
possible net operating loss. Therefore, in a case of anticipated net capital gains, a short-term
Subchapter S election may be attractive when a sale of this kind is anticipated.

specified a particular procedure and, in this case, a particular form which should be followed literally.

The Commissioner also has decreed that the taxable year of a new corporation begins, for purposes of Subchapter S, when the corporation obtains subscribers or shareholders, acquires assets, or begins doing business, whichever is first to occur. Therefore, to avoid the danger of ineligibility for Subchapter S status during its first taxable year, a new corporation intending to elect under the statute should compress its organization and election procedures into a few days. A “desk drawer” corporation should never be used.

Once made, the Subchapter S election continues from year to year until terminated, whether voluntarily or involuntarily, or revoked by affirmative action of the corporation.22

A Subchapter S Corporation Must Be Protected Against Undesired Disqualification

This is important for several reasons. A corporation which becomes disqualified under the statute cannot re-elect Subchapter S status for a period of five years after the first year for which the termination is effective without permission of the Commissioner. Even if the termination was genuinely accidental and produced no tax advantage so that the permission can be obtained, the permission to re-elect cannot be retroactive and ordinarily is impossible to obtain for the year of disqualification. The earnings of an electing corporation which have been previously taxed to shareholders but not yet distributed to them become “locked in” upon termination of the election;23 their subsequent distribution to shareholders can be made only at a cost to them of a second tax at their ordinary income rates.

Unfortunately, preventing an undesired disqualification is neither easy nor certain. The principal hazard arises from the fact that if stock of a Subchapter S corporation is transferred to a person who is not a shareholder at the beginning of the initial taxable year of the election period, the election will be terminated unless the new shareholder (a) is a citizen or resident alien individual who (b) files his consent within thirty days of the time he receives the shares of the corporation.24 To control

22. Although the election for a taxable year must be made during the one month prior or the one month subsequent to the commencement of that year, the various requirements which Subchapter S imposes upon an electing corporation need not be satisfied before the day on which the election is made. See Reg. § 1.1372-1 (1959).
24. Reg. § 1.1372-3(b) (1959), as amended, T.D. 6615, 1962-2 CUM. BULL. 205. If an estate acquires the stock of an electing corporation, however, the 30-day period does not begin to run until the executor or administrator has qualified under local law. Yet in no event may the period commence later than 30 days after the close of the taxable year in which the estate becomes a shareholder of the corporation.
the risk that a transferee will not qualify or not consent, a Subchapter S corporation should prohibit the transfer of stock without a prior offer to the corporation and to its shareholders. This restriction should be included in the articles of incorporation and noted on the face of the certificates. The corporation should, in addition, be sure that each shareholder has a valid will obligating his executor to file a timely consent to continue the Subchapter S election. Without such a provision, an executor may properly refuse to do so where the interest of the estate would best be served by terminating the election. The corporation should assure, as best it can, that a deceased shareholder’s executor qualifies and acts promptly pursuant to such a provision, particularly if the death occurs near the end of the corporation’s fiscal year.25

Violations of the other requirements imposed upon an electing corporation under Subchapter S usually can be avoided through careful supervision. Thus, an electing corporation must not acquire a subsidiary, issue a class of stock other than common stock,26 or permit its gross receipts to violate the 80% “active conduct” income rule. Compliance with the latter requirement may be facilitated by carefully policing the timing of abnormal dividends and gains from sales or exchanges of securities, and if necessary by the sale of tangible assets at a gain when disqualifying receipts threaten to exceed 20% of income.

Each Year’s Earnings Should Be Distributed In Cash Within That Year To the Extent Possible

It will be recalled that an electing corporation’s net income is taxed to the shareholders as though the entire amount had been earned by them. The part of the income which actually is distributed in the form of cash dividends is taxed to the shareholders at the time of the distribution. The balance of the corporation’s net income, called undistributed taxable income, is taxed to the shareholders at the end of the year as if it had been distributed to them as a cash dividend.27

In principle, the shareholders have a right to a subsequent tax-free distribution of this previously taxed but undistributed income. Under the Regulations, however, several hurdles stand in the way of an electing corporation which seeks to make such a tax-free distribution: (a) the undistributed income account is personal to the shareholder to whom it was previously taxed and cannot later be distributed to a transferee share-

26. Reg. § 1.1372-4(b) (1959), as amended, T.D. 6615, 1962-2 CUM. BULL. 205. It will be remembered that notes payable to shareholders of a corporation which is too thinly capitalized may be treated as a disqualifying second class of stock under Reg. § 1.1371-1(g) (1959).
27. CODE § 1373.
holder (including an estate) without a regular dividend tax;\(^{28}\) (b) net 
operating losses in other years reduce the amount of such undistributed 
earnings; (c) such earnings cannot be distributed after the Subchapter 
S election has terminated without being subject to a regular dividend tax.

As indicated above, a corporation's election may terminate accidentally 
(e.g., upon the death of a shareholder near the end of a fiscal year) de-
spite the best of precautions.

For the above reasons, it is important to distribute, insofar as possible, 
the full earnings of an electing corporation in the year in which they are 
received. Many enterprises, of course, need to retain a portion of their 
annual earnings for current operations. In the case of an electing corpo-
ration, funds needed impermanently for current operations should be ob-
tained by corporate borrowings from banks or other third persons to the 
extent possible. If shareholders are the only practicable source for tem-
porarily needed funds, borrowings from them should be made at times 
other than at year-end, should not be in proportion to their share own-
ership, and should be in amounts different than the annual distributions to 
such shareholders.

The reason for these precautions is that reinvestment by shareholders 
of distributed funds through loans in proportion to their stock ownership 
in the electing corporation may invite attack on the ground that the notes 
were really stock in a corporation too thinly capitalized. Where this at-
tack is successful, the Subchapter S status of the corporation might termi-
nate on the ground that the corporation had more than one class of shares 
outstanding. Alternatively, shareholder loans to the corporation in pro-
portion to stock ownership might invite attack on the ground that the 
notes, although valid, were themselves non-cash distributions of the corpo-
ration. In this case, the notes would be taxed to shareholders as actual 
distributions, but would not serve to reduce the amount of the year-end 
constructive distribution taxable to them.\(^{29}\)

A Subchapter S Plan Should Provide for Orderly Termination of 
Subchapter S Status

The necessity for policing transfers of shares, the hazard of uninten-
tional disqualification through untimely death, and the near-inevitability 
of eventual conflicts of interest among shareholders all dictate that the 
well designed Subchapter S plan will incorporate provisions for orderly 
termination of that status. The right time to terminate is likely to be 
when start-up losses have been eliminated and the annual income of the 
corporation is large enough that, if all of it were taxed directly to the
shareholders, some shareholder tax brackets would be substantially higher than the applicable corporate tax bracket. Deliberate termination of the Subchapter S status also may become advisable if shareholders desire to eliminate restrictions on transfer of their shares, or if they otherwise find the Subchapter S operating rules too onerous.

Subchapter S status may be eliminated voluntarily in two ways. For a formal “revocation,” all shareholders must elect to revoke a Subchapter S election before the end of the first month of a taxable year. Alternatively, a corporation may deliberately disqualify itself at any time during the year by, for example, having a shareholder make a bona fide transfer of shares to a trust or to a new shareholder who subsequently does not consent to the Subchapter S status. So long as the transfer is not qualified by an obligation to retransfer or a retained beneficial interest, its bona fides should not be impeached by the fact that it was motivated by a desire to terminate the election.

Some Important Peculiarities in the Application of Subchapter S

Even when used in the common situations discussed in this article, Subchapter S involves several peculiarities to which the electing corporation and its counsel should be alert.

Transfer of Shares

When the shares of an electing corporation are transferred in the midst of a taxable year, undistributed income for the entire year is included in the income of the transferee who holds the shares at year-end. If a corporation ends the year with a net operating loss, however, the loss is prorated to the transferor and transferee on a daily basis. Provision should be made for these tax effects in the event of the transfer of shares of an electing corporation.

If the transferee of Subchapter S shares pays less than book value for his stock, he may not be able to use his full share of corporate operating losses. Such losses can be used by shareholders only to the extent of their bases in stock and indebtedness of the corporation. A shareholder confronted with the limitation, therefore, should consider a year-end loan to the corporation.

30. In the case of a family corporation, a weighted average of the shareholders' individual tax brackets may be the proper figure to compare with the applicable corporate bracket.
31. \textit{Code} § 1372(e) (2) (A).
32. \textit{Code} § 1373(b).
33. \textit{Code} § 1374.
Capital Gain and Loss

The capital gains of an electing corporation retain their character in the hands of shareholders whether constructively or actually distributed to them. As a consequence of this rule, the status of gains to the electing corporation will be affected by the dealer status of the shareholder to whom the gains are taxed. Corporate capital gains are reduced by corporate operating losses before being reflected in shareholder returns. Capital losses do not pass through to the shareholders. As in the case of a non-electing corporation, such losses must rather be carried forward to be deducted from capital gains which the corporation realizes in the five succeeding years.

Loss of Corporate Level Benefits

While avoiding most corporate level taxes, the Subchapter S corporation loses the 85% dividend received deduction, the credit for tax exempt interest, the foreign tax credit, and the deduction for net operating loss carrybacks and carryovers. State income tax disadvantages also may arise, for in some states an electing corporation may not be entitled to the deduction granted for federal income taxes paid.

Loss of Shareholder Level Benefits

With respect to both actual and constructive dividends, shareholders of an electing corporation are not entitled to the fifty dollar exclusion from gross income, the 4% dividend credit, or the retirement income credit.

Ohio shareholders of Subchapter S corporations normally should forego the privilege of the federal election in computing Ohio intangible property tax. Under that election, according to the Ohio Tax Commissioner, shares of corporate income treated for federal tax purposes as a part of shareholder income are treated by state law as a part of income yield. Where no federal election is made, only amounts actually distributed need be counted.

34. Reg. § 1.1375-1(d) (1959).
35. 5 CCH 1963 STAND FED. TAX REP. ¶ 4849.023.
36. See 1 CCH OHIO STATE TAX CAS. REP. ¶ 20-330.