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***395** EVALUATING A SUBCHAPTER S CONVERSION

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***396** I. INTRODUCTION

The Tax Reform Act of 1986 [FN1] has brought about a rush to Subchapter S of extraordinary proportions reminiscent of the California Gold Rush of 1849. The *Wall Street Journal* reports that the IRS expects a substantial increase in the number of Subchapter S tax returns. [FN2] While some of this increase may be attributable to an increase in the number of new businesses operating as S corporations, the potential benefits of a Subchapter S conversion have not escaped tax practitioners. Many practitioners are considering conversions to Subchapter S for their corporate clients. The impetus for the flood of new Subchapter S elections has been twofold: (1) the inversion of the relative tax rates of corporations and individuals, [FN3] and (2) the repeal of the *General Utilities* doctrine [FN4] and the resultant double taxation of gain upon the sale and liquidation of an incorporated business.

Like gold, Subchapter S tax status promises a commodity-enormous tax savings-ultimately convertible into the most desirable commodity of all-money. However, like the California Gold Rush of 1849, a Subchapter S election may be a mirage for many, promising much but delivering little. And, like the California Gold Rush, the longer one waits to try to strike it rich with an S election, the smaller the chance of a successful find, due to the transitional rules [FN5] of the 1986 Act, various new provisions enacted in the 1986 Act [FN6] and in the Revenue Act of 1987, [FN7] and possible future curtailment of the benefits of Subchapter S.

Nevertheless, many Subchapter C corporations could benefit from a conversion to Subchapter S. This article will address how to evaluate whether a particular corporation is a good candidate for a Subchapter S conversion***397** in light of the numerous tax, legal, and practical considerations affecting the corporate form.

Since most corporate clients are drawn to Subchapter S by the potential benefits of the election, any evaluation of a Subchapter S conversion should begin with a critical assessment of the extent to which these potential benefits can be realized by a particular corporate client.

II. ADVANTAGES OF A SUBCHAPTER S CONVERSION

The tax rate inversion and the repeal of the *General Utilities* doctrine by the 1986 Act are the most frequently cited reasons for converting to Subchapter S. However, there are myriad other benefits which can be obtained through a Subchapter S conversion.

A. *Pass-Through of Corporate Losses*

Operating losses of a Subchapter C corporation for a particular taxable year can only be used to offset income of that corporation in prior or subsequent years. [FN8] However, operating losses of an S corporation are passed through to its shareholders [FN9] and, subject to the passive loss rules, [FN10] can be utilized against shareholder income from other sources.

This pass-through of corporate losses to shareholders was the principal reason new businesses and newly incorporated businesses elected Subchapter S prior to the Tax Reform Act of 1986. Since the owners of a new business frequently had income other than the income generated by the business itself, the owners could utilize start-up operating losses against other income. In many cases this pass-through of corporate losses to shareholders obviated the need to wait until the business generated profits to obtain the tax benefit of the operating losses. Prior to the Tax Reform Act of 1986, the pass-through of corporate losses was also a significant reason for a mature business to convert to Subchapter S if corporate operating losses were anticipated***398** and the corporation still had loss carryovers after exhausting its carrybacks. [FN11]

The passive loss rules enacted by the Tax Reform Act of 1986 have largely eliminated this reason to elect Subchapter S status. Under the passive loss rules, losses and credits from an activity in which the taxpayer does not materially participate are currently deductible or creditable only against the income or tax liability arising from other passive activities which generate net income. [FN12] Thus, the pass-through of corporate losses to shareholders who do not materially participate in the enterprise now results in a current deduction of the losses only for shareholders fortunate enough to have other sources of passive income. While losses for shareholders having no other sources of passive income are deductible in future years against passive income from the business from which the losses arose, [FN13] such a carryover is not significantly different from the deduction of net operating loss carryovers of Subchapter C corporations and hence offers no substantial advantage over retaining Subchapter C status. [FN14]

Notwithstanding the enactment of the passive loss rules, conversion to Subchapter S status may still be attractive to permit the pass-through of corporate losses to shareholders who either materially participate in the business or who have other sources of passive income to absorb Subchapter S losses. Thus, the benefits to be derived from the pass-through of corporate losses under Subchapter S after the 1986 Act must be evaluated not only in light of past corporate income or losses and the prospects for future corporate income or losses, but also in light of both the level of involvement of each shareholder in the operation of the business and the personal tax situation of each shareholder.

***399** B. *Avoidance of Double Taxation of Corporate Earnings*

Subchapter C corporations pay income tax on their earnings at the corporate level. [FN15] Any corporate earnings distributed to shareholders as dividends are also subject to imposition of income tax at the individual level. [FN16] This results in double taxation of corporate earnings distributed to shareholders as dividends.

An S corporation, on the other hand, can distribute its earnings accrued during Subchapter S years without incurring double taxation, since generally there is no income tax imposed at the corporate level. [FN17] Instead, such earnings, whether or not distributed, are taxed only at the individual level under the pass-through principles of Subchapter S. [FN18] Distributions of such earnings under Subchapter S are not taxed to the shareholder to the extent the distributions do not exceed the amount of the corporation's income for Subchapter S years which has not previously been distributed to shareholders. [FN19]

Prior to the Tax Reform Act of 1986, the avoidance of double taxation of corporate earnings distributed to shareholders was frequently the predominant reason for converting to Subchapter S for those corporations paying dividends. Prior to 1987 the highest effective federal tax rate on that part of the corporate income of a Subchapter C corporation which was distributed as dividends was 73%, [FN20] while the highest effective federal tax rate ***400** on corporate income of an S corporation which was distributed to shareholders was only 50%. [FN21] This effective rate differential of 23% led many C corporations to convert to Subchapter S.

Following the Tax Reform Act of 1986, the avoidance of double taxation on corporate earnings distributed as dividends remains a significant reason for electing Subchapter S tax status. Beginning in 1988 the highest effective federal tax rate on corporate income distributed as dividends is 52.48%, [FN22] while the highest effective federal tax rate on corporate income of an S corporation distributed to shareholders is only 28%. Thus, the effective rate differential of 24.48% after the Tax Reform Act of 1986 is actually slightly larger than the effective rate differential prior to the 1986 Act. Consequently, the avoidance of double taxation of corporate earnings distributed as dividends is an even more compelling reason for a Subchapter S conversion after the 1986 Act than before.

C. *Rate Inversion Under the Tax Reform Act of 1986*

Under the law in effect prior to the enactment of the Tax Reform Act of 1986, the top marginal corporate rate was 46%, while the top marginal individual rate was 50%. Effective beginning in 1988 the Tax Reform Act of 1986 reduced the top marginal corporate rate to 34% (39% in certain ranges of income), [FN23] while reducing the top marginal individual rate to 28% (33% in certain ranges of income). [FN24] Thus, since the top individual rate was 4% *higher* than the top corporate rate before the 1986 Act, while it is now 6% *lower* than the top corporate rate, there has been a 10% inversion in the relative tax rates of high income corporations and individuals due to the tax rate changes enacted in the 1986 Act.

While significant, in most cases this inversion in the relative corporate and individual rates is not likely to be conclusive in determining whether to convert to Subchapter S, due to the myriad other considerations present in making a conversion. It is, however, likely to be more significant in deciding whether to elect Subchapter S for a new business or newly incorporated business, because the basic highest marginal tax rate on corporate income will be 6% lower under Subchapter S than it will be under Subchapter C. In a ***401** newly incorporated business having shareholders who materially participate in the business, this rate differential is especially significant when viewed in conjunction with the pass-through of corporate losses to shareholders.

This inversion of rates is particularly significant to owners of certain personal service corporations. Under provisions enacted in the Revenue Act of 1987, all taxable income of a ‘qualified personal service corporation’ [FN25] is taxed at a rate of 34%. [FN26] Since the effect of this provision is that such corporations cannot utilize the lower corporate tax brackets, the taxation of corporate income at lower personal tax rates will be especially attractive to these corporations.

D. *Avoidance of Double Taxation on Corporate Appreciation*

After 1988, electing Subchapter S is the only way for a corporation to avoid corporate tax on the appreciation in the value of its assets upon the sale of those assets by either the corporation or its shareholders. Due to the repeal of the *General Utilities* doctrine, [FN27] a C corporation is no longer able to avoid corporate tax upon the distribution of appreciated assets to its shareholders [FN28] or upon the sale of such assets followed by a liquidating distribution of the sale proceeds to its shareholders. [FN29] In contrast, a former C ***402** corporation which has been an S corporation for at least ten years can avoid any corporate level tax on the sale of appreciated assets. [FN30] Moreover, a former C corporation can avoid corporate level tax on a sale with respect to appreciation accruing after the effective date of the Subchapter S election regardless of the length of time it has been an S corporation. [FN31]

As with the rate inversion caused by the 1986 Act, the avoidance of double taxation on corporate appreciation will be a more significant reason to elect Subchapter S status for newly incorporated businesses than for existing corporations converting to Subchapter S. A newly incorporated business which has elected Subchapter S is not subject to the corporate level tax on the sale of appreciated assets regardless of the length of time it has been an S corporation. [FN32] Thus, unlike a corporation which has converted to Subchapter S, a newly incorporated business which elects Subchapter S has no waiting period which must expire before appreciated assets can be sold without the imposition of a corporate level tax.

The benefits of the avoidance of corporate tax on the sale of appreciated assets under Subchapter S were more significant for corporations converting to Subchapter S prior to 1987 and for certain small corporations convering to Subchapter S prior to 1989, due to the transitional rules enacted as part of the 1986 Act. Under these transitional rules a corporation converting to Subchapter S pursuant to an election filed prior to 1987 avoids corporate tax on the sale of appreciated assets if it has been an S corporation for at least three years prior to the sale. [FN33] A qualified small corporation ***403** filing a Subchapter S election prior to 1989 also avoids corporate tax on the sale of appreciated long-term capital gain property if it has been an S corporation for at least three years prior to the sale. [FN34]

E. *Increase in Stock Basis for Retained Corporate Earnings*

An S corporation shareholder's tax basis in his or her stock is increased by such shareholder's share of income items of the corporation [FN35] and is decreased by such shareholder's share of loss and deduction items of the corporation and by distributions of income which have been previously taxed to the shareholder. [FN36] As a result of this basis adjustment mechanism, the tax basis of an S corporation stockholder in his or her stock is increased by such shareholder's share of net retained corporate earnings. A Subchapter C corporation shareholder enjoys no similar adjustment to the basis of his or her stock. If a corporation contemplates retaining any portion of its corporate earnings under Subchapter S, this basis adjustment can substantially reduce a stockholder's gain or substantially increase a stockholder's loss on the sale of his stock. This adjustment to an S corporation stockholder's tax basis in his stock is particularly significant in light of the elimination of the rate differential between the taxation of capital gains and the taxation of other types of income, due to the repeal of the capital gains deduction in the 1986 Act. [FN37]

F. *Absence of Constructive Dividend Controversies*

Upon audit of a C corporation, the IRS frequently disallows a corporate deduction for a payment to or for the benefit of a shareholder and treats the payment as a constructive dividend to the shareholder-payee. For instance, many cases have allowed the IRS to recharacterize unreasonable compensation to shareholder-employees as dividends. [FN38] The IRS also has frequently ***404** reclassified excessive rent to a shareholder-lessor as dividends. [FN39] Other expenditures, such as entertainment expenses, have also been disallowed as corporate deductions and treated as constructive dividends to the shareholder-employee who enjoyed the benefit of the expenditure. [FN40]

While the issue of the deductibility of these payments remains under Subchapter S, the incentive for an IRS agent to attack these issues dissipates, since dividends of Subchapter S earnings are not subject to double taxation. If the payments are determined to be non-deductible, the recharacterization of such payments as dividends will usually not result in additional tax liability, since dividends of Subchapter S earnings are not taxed to the payee. [FN41] While the disallowance of such deductions and recharacterization of such expenditures as dividends could result in a reallocation of corporate income among the shareholders, [FN42] the compression of the ***405** relative tax rates under the 1986 Act [FN43] makes it less likely that the government could obtain significant tax revenue from such a reallocation of income. [FN44] There is little evidence that the IRS will aggressively pursue these issues with S corporations, since less tax revenue is at stake.

G. *Avoidance of Penalty Taxes Imposed on Subchapter C Corporations*

Generally Subchapter C corporations are subject to certain penalty taxes, such as the accumulated earnings tax [FN45] and the personal holding company tax. [FN46] S corporations, however, are not subject to these penalty taxes, since S corporations are not generally subject to any of the income taxes imposed by Chapter 1 of the Internal Revenue Code. [FN47] The avoidance of ***406** these penalty taxes can be a compelling reason for some corporations to convert to Subchapter S, particularly in light of the high rates at which these taxes are imposed. [FN48] However, because of the tax imposed on excess passive investment income of an S corporation having Subchapter C accumulated earnings and profits, [FN49] and because of the termination of the S election for such a corporation having excess passive investment income for three consecutive years, [FN50] a Subchapter S conversion is of only limited utility for many C corporations having personal holding company tax problems. [FN51]

S corporations also avoid the corporate alternative minimum tax imposed by I.R.C. section 55. While an S corporation passes through items of tax preference to its shareholders, the pass-through of these items to shareholders under Subchapter S may be less onerous than the corporate alternative minimum tax for a number of reasons. First, because an S corporation shareholder may have other sources of income, it may be less likely that minimum tax will be imposed at the shareholder level under Subchapter S than at the corporate level under Subchapter C. [FN52] Second, the adjusted book ***407** income and adjusted earnings and profits preferences applicable to corporations do not constitute items of tax preference which pass through to shareholders of S corporations. [FN53] This latter reason not only makes the imposition of alternative minimum tax less likely under Subchapter S; it also permits an S corporation to avoid the extensive calculations involved in computing these items of tax preference.

H. *Use of Subchapter S to Shift Income Among Family Members*

A conversion to Subchapter S presents a limited opportunity to shift income among family members by intra-family gifts or stock sales not available to shareholders of a C corporation. Since shareholders of S corporations are taxed on their share of all corporate income, while shareholders of C corporations are taxed only on income distributed as dividends, transfers of stock among family members shift taxability to a greater extent under Subchapter S than under Subchapter C. This enhanced ability to shift income among family members, when coupled with the tax rate inversion between corporations and individuals under the 1986 Act, makes a Subchapter S conversion an attractive vehicle for family income tax planning.

The capacity to reduce family tax liability through transfers of S corporation stock among family members has been severely reduced by tax law changes enacted in the 1986 Act. The so-called ‘kiddie tax’ enacted in the 1986 Act subjects net unearned income in excess of specified limits of children under age fourteen to income tax at a rate equal to the rate at which such income would have been taxed if it had been included on the parents' ***408** return. [FN54] This change effectively eliminates income shifting techniques involving young children and S corporation stock. In addition, the tax rate compression [FN55] occurring by virtue of the change in tax rates under the 1986 Act greatly reduces the magnitude of the benefits of any income shifting techniques. Thus, the use of an S corporation to shift income among family members is a less significant reason for electing Subchapter S after the 1986 Act.

The extent to which income can be shifted among family mambers is also limited by provisions enacted in the Subchapter S Revision Act of 1982. Under these provisions the IRS may adjust the income of any family member of a stockholder who receives inadequate compensation for services rendered or capital furnished to an S corporation. [FN56] This provision prevents S corporations from increasing the income shifting potential of the corporation by reducing payments to higher income family members. This provision has also been used by the IRS to prevent the recognition of the transfer of shares to non-participating family members. [FN57]

I. *Establishment of Passive Income Generator to Absorb Shareholders' Passive Losses*

A conversion to Subchapter S may enable shareholders who do not materially participate in the business to utilize otherwise non-deductible passive losses from other investments. Under the passive loss rules, an individual can generally offset passive losses only against items of passive income. [FN58] After conversion to Subchapter S, business income which passes through to any shareholder who does not materially participate in the business becomes passive income. [FN59] In contrast, any dividends paid to the shareholder while the business is a C corporation constitute portfolio income, [FN60] which cannot be sheltered with passive loss deductions from other investments. Thus, by converting to Subchapter S, non-materially-participating shareholders can accelerate their deductions for passive losses by netting them against their share of the corporation's income in computing the sllowable passive loss deduction.

***409** J. *Absence of Accrual Accounting Requirement for Corporations Having Income in Excess of $5,000,000*

The Tax Reform Act of 1986 enlarged the group of taxpayers required to use the accrual method of accounting. Under I.R.C. section 448, any C corporation, with certain designated exceptions, [FN61] is required to use the accrual method of accounting if its average annual gross receipts for a specified base period exceed $5,000,000. S corporations, however, are not subject to this rule and may use the cash method of accounting regardless of the level of annual gross receipts. [FN62]

As with many other Subchapter S benefits, this advantage of S corporation status is not significant for most corporations considering a Subchapter S conversion for several reasons. First, the change in the method of accounting requirement under the 1986 Act only affects corporations having more than $5,000,000 of average annual gross receipts. Smaller businesses are not affected by the change and hence will have no incentive to convert to Subchapter S as a result of the change. Second, if the business carries inventories, the business will in any event be required to use the accrual method of accounting. [FN63] Thus, this benefit of a Subchapter S election will be enjoyed only by businesses which do not carry inventories and which have average annual gross receipts in excess of $5,000,000. [FN64] Third, any existing corporation will already have converted to the accrual method of accounting pursuant to the amendment to I.R.C. section 448 by the Tax Reform Act of 1986, and consequently any existing corporation considering a Subchapter S conversion***410** will have to apply to the IRS for a change of accounting method [FN65] to the cash method of accounting to take advantage of this benefit of Subchapter S. Since the IRS generally disfavors the cash method of accounting and has a great deal of discretion in deciding whether to grant such a request, [FN66] it may be difficult to obtain permission to change to the cash method of accounting. Even if a change of accounting method to the cash basis is granted, conditions imposed by the IRS in order to clearly reflect income may limit the benefit of the conversion to the cash method. [FN67] Thus, only larger businesses which do not carry inventories will enjoy this benefit of a Subchapter S election, and only those corporations able to obtain IRS approval of a change in accounting method will enjoy this benefit upon a conversion to Subchapter S.

III. DISADVANTAGES OF A SUBCHAPTER S CONVERSION

With most things in life, some bad comes with the good. A Subchapter S conversion is no exception. The evaluation of a possible conversion to Subchapter S should include an analysis of the extent to which these detriments affect the client.

A. *Loss of Corporate Surtax Exemptions and Lower Corporate Rates*

While the highest marginal tax rate of a C corporation is higher than the highest marginal rate for individuals, a C corporation having income of less than $75,000 may have its income taxed at lower marginal rates. These rates are 15% for the first $50,000 of taxable income and 25% for the next $25,000 of taxable income. [FN68] While these lower corporate rates (or surtax exemptions) are phased out by the imposition of tax at a rate above 34% for ***411** incomes above $100,000, [FN69] these lower rates for companies having modest incomes can be advantageous if it is necessary to reinvest profits in the business.

If the business owners are in relatively high individual tax brackets and the corporation is in relatively low tax brackets, the earnings of a business operating as a C corporation can be retained in the business and taxed at a lower tax rate than if the corporation were an S corporation. For instance, a C corporation having income of $50,000 can retain the income in the business by paying corporate income tax on that income at the rate of 15%, leaving 85% of the earnings available for reinvestment in the business. An S corporation having shareholders in the 28% tax bracket will pay individual income tax on the entire retained corporate earnings at the rate of 28%, leaving only 72% of the earnings available for reinvestment (*e.g.*, through loans or capital contributions made to the business). While under Subchapter C the earnings retained in the business will again be subject to income tax upon distribution as dividends to the shareholders or upon liquidation of the business, corporations having modest incomes which need to reinvest earnings for growth are frequently more concerned with how to get more capital in the business than with the tax implications at some indefinite point in the future. Tax savings and the resultant cash flow when the income is earned may simply be more important to the business than later tax ramifications. Moreover, the present value of the future adverse tax consequences of retaining corporate income under Subchapter C may be perceived to be insubstantial if it is not contemplated that the earnings will be distributed or the assets of the business sold in the foreseeable future.

Moreover, even corporations having larger apparent corporate income can in many cases take advantage of the lower corporate tax rates on incomes of less than $75,000 by paying bonuses to shareholder-employees or by periodically adjusting rents to shareholder-lessors. Such action is, however, subject to the risk that the IRS could reclassify the bonuses or increased rents as constructive dividends to the shareholder-payees. [FN70]

The detriment of a conversion to Subchapter S of loss of the lower corporate rates on incomes of the business of less than $75,000 is a lesser detriment to an S election after the Tax Reform Act of 1986 than it was before, due to the rate inversion caused by the 1986 Act. Prior to the 1986 Act, it was an unusual case in which corporate earnings could be reinvested in a business with lesser tax by an S corporation than by a C corporation, since individual tax rates were generally higher than corporate tax rates. However, after the 1986 Act the retention of corporate earnings in a Subchapter C format will only generate current tax savings if the corporation has modest income and if the shareholders are in higher tax brackets.

***412** Moreover, the Revenue Act of 1987 eliminated this detriment to a Subchapter S conversion for certain personal service corporations. Under provisions of the 1987 Act, all of the income of a qualified personal service corporation is taxed at the highest marginal corporate tax rate (34%). [FN71] For such corporations, Subchapter S has become more attractive since this benefit of Subchapter C status has been removed.

The loss of the lower corporate tax brackets is usually a less significant consideration for a mature business considering a conversion to Subchapter S than for a newly incorporated business selecting a form of corporate organization, since mature businesses typically have hgiher business income expectations than newer businesses. Under the Tax Reform Act of 1986, C corporations having incomes from $100,000 to $335,000 will lose some of the benefits of the lower tax brackets, while C corporations having incomes greater than $335,000 will obtain no benefit at all from the lower tax brackets by virtue of the imposition of a 5% surtax on incomes between $100,000 and $335,000. With higher income expectations, it becomes increasingly unlikely that the lower corporate tax brackets can be utilized to reduce the tax cost of reinvesting corporate earnings in the business.

B. *Adverse State Income Tax Effects of a Subchapter S Election*

In many states, the state income tax effects of the conversion to Subchapter S can be the most significant deterrent to converting to Subchapter S. The determination of the state income tax effects of the conversion will be dependent upon the corporate income tax apportionment formulas of the states which have jurisdiction to tax the corporation and its shareholders; the application of these formulas to the particular asset, expense, and sales mix of the corporation; the application of any ‘throwback’ rules; and the manner in which S corporations and their shareholders are taxed by such states.

States handle the taxation of corporations conducting interstate businesses in many different fashions. Most states apportion business income to their state by a formula based upon one or more of three factors-property, payroll, and sales. [FN72] Under these apportionment formulas the income of the corporation is apportioned to the state in proportion to the relative ratios of the amount of these factors in the state to the amount worldwide. For example, in Iowa corporate business income is apportioned to the state in the proportion which the amount of sales within Iowa for the year bears to the ***413** total amount of sales worldwide for the year. [FN73] Some states have adopted a ‘throwback’ rule under which the state also taxes the income which would have been apportioned to other states under its apportionment formula but which is not taxed in such other states because the corporation lacks the minimum contacts with such other states necessary to establish jurisdiction to tax. [FN74]

The applicable apportionment formula can have drastically different corporate income tax effects on a business depending upon its mix of property, payroll, and sales. For instance, an Iowa business making all of its sales within the state of Iowa will have 100% of its income subjected to the Iowa corporate income tax. In contrast, an Iowa business making 5% of its sales within Iowa will have only 5% of its income taxed under the Iowa corporate income tax. [FN75] If such a corporation is not subject to the taxing jurisdiction of any other state because of the absence of minimum contacts, then-since Iowa has no throwback rule-the corporation will effectively pay state income tax on only a small portion of its income as a C corporation.

This state income tax effect on a C corporation should be compared with the state income taxes on corporate income under Subchapter S. As with state apportionment formulas, the methods by which states tax the income of S corporations very widely. Most states do not tax S corporations as such and tax the corporate income on the shareholders' returns in the same manner as at the federal level. [FN76] Seven states and the District of Columbia ***414** treat Subchapter S corporations in the same manner as C corporations and subject these corporations to the regular state corporate income tax. [FN77] Five states impose no state income tax. [FN78]

Superimposed on the various states' methods of taxing S corporations is the manner in which they tax the income of a shareholder of an S corporation. States which do not recognize S corporations tax only the dividends received by resident shareholders from the corporation. [FN79] States which use the federal pass-through approach, such as Iowa, tax all of a resident shareholder's share of corporate income in the same manner as at the federal level, and tax a portion of a nonresident shareholder's share of corporate income determined by applying an apportionment formula. [FN80] Shareholders who pay state income tax on corporate income in several states will typically be given a credit in their state of residency for the income tax paid to other states.

This complex and inconsistent state income tax treatment can have anomalous results. For instance, the hypothetical business headquartered in Iowa which had only 5% of its sales within Iowa will have only a small amount of Iowa corporate income tax to pay under Subchapter C, since Iowa has no throwback rule. If such a corporation has no minimum contacts with other states, the Iowa corporate income tax will be the only state corporate income tax it will pay. If such a corporation has only shareholders who are Iowa residents, under Subchapter S all of the corporate income will be subjected to tax under the pass-through concept used in Iowa. Thus, the aggregate state income tax liability of the corporation and its shareholders will be substantially increased as a result of an S election. However, the shareholders***415** of the hypothetical business having all of its activities within the state of Iowa and having only Iowa resident shareholders will have the same amount of income subjected to tax under Subchapter S as the corporation did as a C corporation. [FN81] For such a corporation, the state income tax effect of a conversion to Subchapter S will be measured only by the relative state income tax rates of the corporation as a C corporation and of the shareholders under Subchapter S.

Another anomaly results where a corporation does business in a state which does not recognize the S election for state income tax purposes and has shareholders who are residents of other states. The corporation will pay state corporate income tax on corporate income properly apportionable to the state. The states of residency of such shareholders will also impose income tax on such income on the shareholders' returns under their Subchapter S principles. While some states permit such shareholders a credit for such shareholders' share of the state income taxes paid by the corporation in this situation, most states do not. [FN82] Thus, in many of these cases double taxation of S corporation income will result from a Subchapter S conversion. [FN83]

The potential state income tax effect of a Subchapter S conversion can have a drastic negative effect which can negate or outweigh the benefits of the conversion, or it can have little or no effect depending on the particular circumstances of the client. An analysis of the state income tax effects of the conversion is therefore critical in assessing the advisability of a Subchapter S conversion. Such an analysis may be very intricate if several states have jurisdiction to tax the corporation and if shareholders reside in several states. It may be relatively simple if all of the corporate business is conducted in the state in which the shareholders reside.

C. *Exposure to Tax on Built-in Gains*

The Tax Reform Act of 1986 amended I.R.C. section 1374 and replaced the corporate level tax on certain net capital gains of S corporations in excess of specified limits with a corporate level tax on ‘recognized built-in ***416** gains' of S corporations. [FN84] Recognized built-in gains are gains recognized on the disposition of any asset by an S corporation within ten years following a conversion to Subchapter S to the extent of the excess of the fair market value of such asset as of the beginning of the first taxable year for which the corporation was an S corporation over the adjusted basis of such asset at such time. [FN85] The intent of this provision was to prevent corporations from avoiding corporate level tax on the sale of an appreciated asset by converting to Subchapter S shortly prior to sale of the asset.

Although the tax on recognized built-in gains of S corporations was designed to resemble the tax treatment of such a gain if the corporation were a C corporation, in two circumstances the imposition of tax on built-in gain upon disposition of an appreciated asset by an S corporation can be more severe than recognition of corporate level gain by a C corporation upon disposition of an appreciated asset.

First, if the C corporation does not distribute its earnings as dividends to shareholders, it recognizes the gain on the disposition of the asset only at the corporate level. While the recognition of the corporate level gain increases the C corporation's earnings and profits and thereby increases the amount of future distributions to shareholders which may be taxed as dividends, there is no current income recognition at the shareholder level if earnings are not distributed. In contrast, if built-in gain of a C corporation is recognized, the corporation is subject to a current corporate level tax on the built-in gain, and such gain is again subject to current taxation at the shareholder level, since the gain, reduced by the corporate level tax on the built-in gain, increases corporate income which passes through to shareholders.

Second, if a C corporation which disposes of an appreciated asset is not in the highest marginal corporate income tax bracket, any gain on the disposition is taxed at a lesser rate. The tax on recognized built-in gains of S corporations, however, is imposed at the highest marginal corporate income tax rate. [FN86] Thus, recognition of a built-in gain by an S corporation may result in greater corporate level tax on such gain than if the corporation remained a C corporation.

While the imposition of tax on built-in gains is generally undesirable, it is a particularly significant concern with respect to sales of inventory after a conversion to Subchapter S. If the fair market value of an item of inventory exceeds its carrying value at the effective date of the Subchapter S election, there is unrealized built-in gain in such inventory which is recognized upon the sale of such inventory. [FN87] While corporations do not generally consider their inventory to be an appreciated asset, a built-in gains problem can arise ***417** in a number of different circumstances. First, if the taxpayer has understated its inventory in prior years in order to increase its cost of goods sold and decrease taxable income, the inventory may be carried at a value substantially less than market value. Second, many taxpayers carrying inventory at the lesser of cost or market have most of their inventory carried at cost rather than market value. To the extent market value of such inventory at the effective date of the Subchapter S election exceeds cost, the inventory contains unrealized built-in gain. Finally, because the IRS has not issued regulations under new section 1374, the meaning of the term 'fair market value' when applied to inventories is unsettled. There have been numerous indications that the regulations which will be promulgated by the IRS under section 1374 may state that, for purposes of the tax on built-in gains, the fair market value of inventory is its retail value rather than its wholesale or liquidation value. [FN88] Since retail value will in almost all cases substantially exceed carrying value, such an interpretation of the term would result in substantial unrealized built-in gain for corporations converting to Subchapter S which carry inventories.

The IRS has announced that, in determining whether an item of inventory has been sold so as to trigger recognition of built-in gains, the method of accounting for inventory sales used by the taxpayer will be used. [FN89] Thus, a taxpayer using a first-in-first-out (FIFO) method will be deemed to have sold the oldest inventory first, while a taxpayer using a last-in-first-out (LIFO) method will be deemed to have sold the most recently produced inventory first. [FN90] A taxpayer on the FIFO method will thus recognize any ***418** built-in gains on such inventory as soon as inventory has turned once, which in most cases will be in the first year as an S corporation. On the other hand, a taxpayer on the LIFO method will recognize any built-in gains on such inventory only if its inventory levels fall below the levels of such inventory held on the effective date of the S election. If inventory levels of such a taxpayer do not decline during the ten-year period after an S election, such a LIFO method taxpayer will not recognize built-in gains on such inventory. Thus, any built-in gains problems in inventory will be particularly significant for taxpayers on the FIFO method of valuing inventory. They will be relatively insignificant for most taxpayers valuing inventory under the LIFO method. [FN91]

While many issues involving the application of the tax on built-in gains remain unresolved, the evaluation of a conversion to Subchapter S should nevertheless include an analysis of exposure to built-in gains tax. Consideration should be given to contemplated sales of substantial amounts of appreciated assets. In addition, if the business carries inventories, the valuation of such inventories should be reviewed to determine the level of exposure to built-in gains tax after the conversion.

D. *LIFO Recapture Under the Revenue Act of 1987*

The Revenue Act of 1987 enacted a provision which will affect the decision to convert to Subchapter S of companies valuing inventory on the LIFO method. Under this provision the excess of the value of inventory under the LIFO method over its value under the FIFO method at the effective date of ***419** the Subchapter S election is recaptured and taken into income by a former C corporation. [FN92] This excess is taken into income ratably over four years beginning in the last C corporation year and continuing for the next three years. It generates a corporate level tax during both the last C year and the subsequent three S years. [FN93]

E. *Possible Loss of Net Operating Loss Carryovers and Other Carryovers*

Under Subchapter S no carryfoward or carryback arising from a Subchapter C year may be carried to a taxable year for which the corporation is an S corporation. [FN94] Moreover, despite the fact that C carryovers cannot be applied against income in an S year, any year for which a corporation is an S corporation will be treated as an elapsed year for purposes of determining the number of taxable years to which an item may be carried forward or back. [FN95] Thus, not only does a conversion to Subchapter S temporarily suspend these tax attribute carryovers, but since S years count as elapsed years a conversion to Subchapter S could result in loss of certain types of carryovers if the corporation does not return to Subchapter C corporation status during the applicable carryover period. As a result of these provisions, corporations with unused carryovers will ordinarily not convert to Subchapter S until such carryovers have been exhausted.

These provisions also limit the use of carrybacks from C years subsequent to loss of Subchapter S corporation status. [FN96] Thus, a corporation wich revokes its S election or otherwise loses Subchapter S corporation status will not be able to carry back net operating losses from its first post S year and obtain an immediate tax refund. Instead, such a corporation would be limited to carrying forward such losses and applying them against income in future Subchapter C years.

F. *Loss of Deductions for Passive Losses from Investments Held by the Corporation*

Certain closely held C corporations [FN97] may offset passive losses not only ***420** against items of passive income but also against any other income of the corporation other than interest, dividends, annuities, royalties, and gain from the disposition of property held for investment. [FN98] Passive losses from corporate investments of an S corporation, however, are passed through to the shareholders under Subchapter S and are deductible only against shareholder income from other passive activities. Thus, C corporations qualifying for this special rule may lose the tax benefits of losses from their passive investments by converting to Subchapter S.

Any C corporation having expected losses or credits from passive activity investments may be able to retain the benefits of this special rule while still converting to Subchapter S by spinning off investments and business interests generating sufficient business income to absorb the passive loss deductions from these investments into another C corporation prior to the conversion to Subchapter S. The retention of these benefits might also be achieved by contributing the investments and business interests to a subsidiary of which less than 80% of the stock is owned by the corporation.

G. *Loss of Dividends Received Deduction*

A C corporation is allowed certain deductions with respect to dividends it receives from other corporations, which are not allowed to S corporations or their shareholders. These deductions include a 100% dividends received deduction for dividends received from small business investment companies and from members of the same affiliated group of corporations, [FN99] a 70% dividends received deduction for dividends received from other domestic corporations, [FN100] a deduction with respect to dividends on preferred stock of a public utility, [FN101] and a deduction with respect to certain 10% owned foreign corporations. [FN102] Corporations having investments generating such dividends will lose these deductions upon a conversion to Subchapter S. However, these corporations may be able to preserve these benefits through corporate reorganizations preceding the conversion to Subchapter S similar to those identified above for corporations owning passive activity investments generating losses or credits. [FN103]

H. *Increased Likelihood of Imposition of Alternative Minimum Tax*

Although in some cases a conversion to Subchapter S may decrease the ***421** prospect of the imposition of alternative minimum tax, [FN104] in other cases alternative minimum tax may become more likely after a conversion to Subchapter S. [FN105]

Whether alternative minimum tax may be made more likely if the corporation is an S corporation than if it is a C corporation will depend on the tax circumstances of the corporation and its shareholders. Since the maximum corporate rate is fourteen percentage points higher than the corporate alternative minimum tax rate, while the maximum individual rate is only seven percentage points higher than the individual alternative minimum tax rate, it will generally take more tax preferences for a corporation to be subjected to alternative minimum tax than for an individual to be subjected to that tax. Moreover, an individual may have other items of tax preference which would not have created alternative minimum tax but for the pass through of the tax preference items of the S corporation. In addition, an individual may have items of tax preference which are not tax preferences for a C corporation, such as excess itemized deductions, which may impact the relative likelihood of the imposition of alternative minimum tax. Finally, the number of shareholders and the relative income levels of the corporation and its shareholders should be considered due to the minimum tax exemption amount and the phase out of the exemption amount under I.R.C. section 55(d)(3).

***422** I. *Inclusion in Income of Cost of Fringe Benefits for Two-Percent Shareholders*

Statutory fringe benefits [FN106] provided by C corporations to shareholder-employees are generally deductible to the employer [FN107] and not includible in the income of the employee. [FN108] However, under Subchapter S shareholder-employees who own, directly or indirectly, more than 2% of the corporation's stock are treated as if they were partners in a partnership, rather than corporate employees, for purposes of applying the employee fringe benefit provisions of the Code. [FN109] Since the provisions of the Code which provide for the exclusion of the cost of such benefits from income apply only to employees, [FN110] the cost of these benefits will be includible in the income of the 2% shareholder-employee for whom they are paid after a conversion to Subchapter S. [FN111]

***423** This harsh consequence of an S conversion is partially offset for shareholder tax years beginning prior to 1990 by the special partial deduction permitted to such shareholder-employees for amounts expended for medical insurance enacted in the Tax Reform Act of 1986. [FN112]

***424** J. *Loss of Flexibility on Loans from Qualified Retirement Plans*

As long as certain non-discrimination requirements are met, shareholder-employees of C corporations can borrow from their retirement plans without running afoul of the prohibited transaction rules of ERISA, due to a statutory exemption for participant loans. [FN113] In contrast, a 5% shareholder of an S corporation is not eligible for the statutory exemption from the prohibited transaction rules of ERISA on participant loans. [FN114]

As a result of the differing treatment of participant loans to 5% shareholders under Subchapter S, outstanding retirement plan participant loans to 5% shareholder-employees must be repaid in full prior to a conversion to Subchapter S in order to avoid a tax on a prohibited transaction under I.R.C. section 4975. [FN115] Alternatively, an administrative exemption from the application of the prohibited transaction rules must be obtained. [FN116] In addition, post-conversion loans cannot be made from such plans to 5% shareholder-employees without subjecting the loan to the prohibited transaction excise tax, unless a prior administrative exemption is obtained. If such a loan exists after the conversion to Subchapter S without an administrative exemption, the qualification of the plan is also in jeopardy. [FN117]

The significance of this detriment to a Subchapter S conversion has been diminished by the amendment to section 72(p)(3) of the Code in the ***425** Tax Reform Act of 1986. [FN118] This provision makes interest paid on a loan from a qualified plan to a key employee non-deductible. [FN119] The term 'key employee' is defined to include any 5% shareholder of the employer corporation. [FN120] Since the term 'key employee' is not limited to a 5% shareholder of an S corporation, the disallowance of the deduction for interest on such a loan applies equally whether the corporation is an S corporation or a C corporation. This provision and other provisions affecting qualified plan loans enacted by the Tax Reform Act of 1986 [FN121] will make participant loans from retirement plans less attractive for 5% owners. Consequently, the inability of a 5% shareholder to obtain a participant loan is of reduced significance after the enactment of the Tax Reform Act of 1986.

K. *Additional Tax Return Complexities Resulting from Subchapter S Election*

In most cases an S conversion will result in more complicated tax returns for both the corporation and its shareholders.

The corporation's tax return may be more complex under Subchapter S than under Subchapter C. Under Subchapter C, a corporation must merely compute its income and calculate its tax. [FN122] While an S corporation in most cases need not calculate a tax liability, it will be required to allocate all separately computed items of income, loss, deduction, or credit, and non-separately-computed income or loss, to its shareholders. If the S corporation has more than a few shareholders, this allocation process will be quite time ***426** consuming and complex. In addition, if there are changes in corporate stock ownership during the year, the allocation will become considerably more complex, due to the requirement that corporate income be allocated on a daily basis based upon stock ownership on each day. [FN123] The relative complexity of the corporate return under Subchapter C and under Subchapter S will be dependent on the relative complexity of any Subchapter C tax accrual, the number of shareholders of the corporation, and the number of changes in stock ownership during the year.

While the corporate return may or may not be more complicated under Subchapter S, the shareholders' tax returns will almost surely be more complex after an S conversion. Shareholders of a C corporation need only enter on Schedule B of their tax returns the amount of dividends from the corporation reported on Form 1099. In contrast, a shareholder of an S corporation will in most cases have several entries to make from line item entries on his Form K-1. These entries will be spread out throughout his tax return and in many cases will generate additional forms and schedules to attach to his return.

In addition to the additional complexities to shareholders' federal returns caused by the conversion to Subchapter S, in many cases shareholders' state tax return filing requirements will also become more complicated. Non-resident shareholders will in many cases become subject to state income tax return filing requirements of the state in which the corporation's principal office is located. In addition, shareholders will in many cases become subject to state income tax return filing requirements of other states in which the corporation transacts business if the corporation is subject to the taxing jurisdiction of such states. To the extent multiple state filing requirements are involved, allocations of corporate income among such states will also be required.

The additional state and federal tax compliance requirements resulting from a conversion to Subchapter S will result in both the corporation and its shareholders incurring more expense in the preparation of their income tax returns. These complexities will also generate some frustration about the difficulty of complying with tax return requirements. This may create antipathy to the Subchapter S conversion.

L. *Non-Tax Detriments of an S Conversion*

In addition to the detriments to an S conversion under various federal and state tax laws listed above, there are also several non-tax detriments to the conversion which are frequently overlooked when the evaluation of the pros and cons of an S conversion is made.

One such detriment is the increased demand by shareholders for the distribution of corporate earnings under Subchapter S. Since shareholders ***427** are being taxed on all corporate earnings whether or not they are distributed under Subchapter S, shareholders naturally tend to feel that these earnings should be distributed to the parties who are paying the tax on them. This increased pressure to distribute corporate earnings may result in the inadequate retention of corporate earnings to meet ordinary business cash needs and to finance corporate growth. If more earnings are distributed under Subchapter S than would have been distributed if the corporation remained a C corporation, the future viability of the business could be threatened.

Because of the tendency of a corporation to distribute more to shareholders as an S corporation than as a C corporation, financial institutions providing financing to the corporation may impose more rigid covenants in loan agreements to ensure the continued financial strength of the company. In addition, such financial institutions may require the shareholders to give personal guarantees of the corporate debt, since the security of the financial institution is otherwise diminished by the distribution of such corporate earnings to shareholders.

The conversion to Subchapter S may also be quite expensive due to the cost of various restructuring maneuvers which may be required in order for the corporation to be eligible to elect Subchapter S. Subsidiaries may need to be liquidated or spun off to comply with the affiliated group limitations of Subchapter S. Trusts may need to be reformed or amended to meet the stock ownership requirements of Subchapter S. The corporate stock owned by such trusts may need to be distributed to the trust beneficiaries in order to meet those requirements. Shareholders may need to be bought out through corporate redemptions or shareholder cross-purchases to comply with the number of shareholders limitations of Subchapter S. This restructuring will inevitably involve substantial transactional costs. In many cases it will also result in various tax costs to the participants in these transactions.

In addition, the corporation may also have to incur post-conversion expenses to maintain Subchapter S eligibility. For instance, if a shareholder dies and leaves his property to several legatees, the corporation may need to buy out some of the legatees to continue to have thirty-five or fewer shareholders. Similarly, if a shareholder dies leaving his stock to a non-qualifying trust, the trust may need to be reformed. Such costs are by their nature unpredictable as to their amount and timing.

Ongoing tax compliance costs will in many cases be higher after a Subchapter S conversion as well. To the extent the corporate income tax return is more complicated due to the requirements of allocating corporate income to multiple shareholders, corporate income tax preparation expense will grow. Similarly, to the extent shareholder returns are made more complicated due to the many tax return line item entries and multiple state filing requirements, shareholder tax preparation costs will also increase.

A Subchapter S conversion will also result in a loss of corporate flexibility.***428** S corporations are limited in their choice of fiscal years. [FN124] Because of the ownership requirements which must continually be met to retain Subchapter S status, the corporation will also lose flexibility in ownership. The corporation will be limited as to the number of shareholders which may be added due to the Subchapter S limits on the number of shareholders. [FN125] The corporation will also be limited to having only shareholders who are individuals (other than non-resident aliens), estates, grantor S trusts or qualified Subchapter S trusts. [FN126] Finally, the corporation will be restricted in its affiliations with other corporate entities due to the affiliated group prohibition of Subchapter S. [FN127] This general loss of corporate flexibility will in many cases be relatively insignificant to the corporation. However, in other cases the loss of flexibility may impair achieving various business and personal objectives of the corporation and its shareholders.

IV. FUTURE CHANGES WHICH MAY AFFECT THE DESIRABILITY OF CONVERTING TO SUBCHAPTER S

Recent experience suggests that the old adage should be changed to: 'There is nothing sure in life except death, taxes, *and changes in the tax law*.' During this decade alone seven major pieces of federal tax legislation have been enacted. [FN128] Given the current state of the federal deficit, there is certainly no reason to think that this tinkering with the tax law will cease in the foreseeable future. In deciding whether a corporation should convert to Subchapter S, a tax practitioner should consider the risks of changes in the ***429** tax law which may deprive the corporation and its shareholders of the benefits sought from a conversion to Subchapter S.

While George Bush pledged that he would enact no new taxes, the possibility of increased tax rates has been left open. If both individual and corporate rates were increased by the same amount, such a rate increase would have little impact on the desirability of converting to Subchapter S, since the desirability of Subchapter S is affected by the relative levels rather than the absolute levels of individual and corporate tax rates. However, if individual tax rates were raised more than corporate tax rates, an S conversion would be less attractive.

There also seems to be a risk that Congress may perceive the conversion of profitable C corporations to Subchapter S, in order to create passive income generators for shareholders having passive activity losses, [FN129] as an abuse of the passive activity loss rules. Legislation or the exercise of regulatory authority limiting the deductibility of passive activity losses against income from an S corporation might be expected in the future.

The final resolution of the question of valuing inventory at the effective date of the S election [FN130] will also affect the relative desirability of converting to Subchapter S. If a retail method of valuation must be used, corporations with FIFO inventories will have a substantial impediment to taking advantage of the benefits of Subchapter S which would otherwise be available.

Finally, there is some risk that Congress may take drastic action to limit the availability of Subchapter S generally in order to protect the federal budget. Such measures may take the form of restricting the availability of Subchapter S by reducing the number of permitted shareholders, limiting the nature of permissible shareholders or restricting Subchapter S to corporations having income or revenue below specified limits. Alternatively, Congress may choose to attack conversions to Subchapter S by enacting legislation treating an S conversion as a corporate liquidation followed by a reincorporation.

While it is impossible to predict what changes in the tax law will be enacted in the next few years which will affect the decision to convert to Subchapter S, it seems certain that there will be tax law changes in the near future and that some of these tax law changes will make a conversion to Subchapter S less attractive than it currently is. Thus, in evaluating whether to make a conversion to Subchapter S, the risk of adverse tax law changes should be factored into the equation. If the benefits of a conversion to Subchapter S are small or uncertain and the costs of effectuating an election are substantial, a conversion to Subchapter S may not be worth the effort. On the other hand, if the benefits of a conversion are substantial and ***430** tangible, an S conversion should probably be effectuated even though the benefits are only temporary. [FN131]

V. CONCLUSION

While precise mathematical calculations have been developed which purport to determine whether a conversion to Subchapter S is desirable, [FN132] the process of evaluating an S conversion is clearly more art than science. The evaluation is not only a function of the incomes of the corporation and its shareholders; it is also dependent on less quantifiable factors. In the final analysis the quality of the evaluation will be dependent upon the practitioner's knowledge of a wide range of matters involving the corporation and its shareholders and the practitioner's application of judgment to the unique circumstances of the client.

[FNa] Brown, Winick, Graves, Donnelly, Baskerville & Schoenebaum, Des Moines, Iowa. B.A. with honors, 1974; J.D. with high distinction, 1977, University of Iowa.

[FN1]. Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).

[FN2]. The *Wall Street Journal* reported that the IRS expected to receive 801,700 Subchapter S returns for 1987, up from 769,100 in 1986 and 564,219 in 1982. The IRS also predicts that it will receive 1,013,900 Subchapter S returns by 1992. Thus 22% of all corporate returns will be Subchapter S returns. Wall St. J., Mar. 22, 1988, at 1.

[FN3]. *See infra* § II.C.

[FN4]. *See infra* § II.D.

[FN5]. I.R.C. § 1379 (1986).

[FN6]. I.R.C. §§ 1361-79 (1986).

[FN7]. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 (1987).

[FN8]. Under I.R.C. §§ 172(b)(1)(A) and (B) (1986), corporate net operating losses generally can be carried back three years and forward fifteen years and applied against corporate income in those years. These losses are first carried back to the three preceding taxable years of the corporation. If they cannot be utilized in those years, they are then carried forward for up to fifteen years. However, under § 172(b)(3)(C) (1986), a corporation can elect to relinquish the carryback period, in which case the losses are only carried forward.

[FN9]. I.R.C. § 1366(a)(1) (1986) provides that a shareholder of an S corporation takes into account his or her pro rata share of the separately computed and non-separately computed items of income or loss of the corporation and separately computed items of deduction or credit of the corporation. Those items of income, loss, deduction, or credit of the corporation the separate treatment of which could affect the tax liability of any shareholder (such as tax-exempt income, charitable contributions, and capital gains and losses) flow through as specific line items on a shareholder's Form K-1, while those items of income or loss which could not selectively affect the tax liability of any shareholder flow through as an aggregate Subchapter S income or loss item.

[FN10]. I.R.C. § 469 (1986).

[FN11]. In addition, prior to the Economic Recovery Tax Act of 1981, the significantly higher individual tax rates frequently made a Subchapter S conversion desirable, since corporate operating losses could be offset against individual tax rates which were substantially higher than the highest marginal corporate tax rate. This benefit of a Subchapter S conversion was significantly curtailed under the Economic Recovery Tax Act of 1981, since the individual rates were substantially reduced and the highest marginal individual rate approximated the highest marginal corporate rate.

[FN12]. I.R.C. §§ 469(a)(1) and (d) (1986).

[FN13]. I.R.C. §§ 469(b) and (d) (1986).

[FN14]. Notably, suspended passive losses which are carried forward to future years are also deductible in future years against income from passive activities other than the activity which generated the loss. I.R.C. §§ 469(b) and (d)(1) (1986). Corporate net operating losses, on the other hand, can be carried over and applied only against income of the corporation which generated the loss. However, corporate net operating losses can be carried back three years, while passive losses can only be carried forward.

In addition, passive losses are deductible against other income upon a taxable disposition of the interest to an unrelated party. I.R.C. § 469(g) (1986).

[FN15]. I.R.C. § 11 (1986).

[FN16]. I.R.C. §§ 301(c)(1) and 316 (1986).

[FN17]. I.R.C. § 1363(a) (1986). However, distributions of appreciated property to shareholders by S corporations generate a corporate level tax. I.R.C. § 1363(d) (1986). A corporate level tax is also imposed on recognized built-in gains which are realized within the first ten years of S corporation status. I.R.C. § 1374 (1986). There is also imposed a corporate level tax on excess net passive income under I.R.C. § 1375 (1986).

[FN18]. I.R.C. § 1366 (1986).

[FN19]. Under the Subchapter S Revision Act of 1982, this result is effectuated through an account known as the accumulated adjustments account. Distributions of an S corporation having Subchapter C earnings and profits are not included in gross income of the shareholder to the extent the distributions do not exceed the balance of the accumulated adjustments account. I.R.C. § 1368(c)(1) (1986). The accumulated adjustments account is an account containing the net amount of all increases and decreases in shareholder basis in stock for all years the corporation has been an S corporation after 1982. I.R.C. § 1368(c)(1) (1986). Under I.R.C. § 1367(a)(1) (1986), such account is increased for corporate income taxed to shareholders by virtue of the pass-through of corporate earnings. Under I.R.C. § 1367(a)(2) (1986), the account is decreased by corporate losses and deductions passed through to shareholders, non-deductible expenses chargeable to capital account, and distributions to shareholders which are not taxed to the shareholders since they are paid out of the accumulated adjustments account. Certain adjustments to basis with respect to depletion under I.R.C. §§ 1367(a)(1)(C) and (a)(2)(E) (1986) are also reflected in the accumulated adjustments account.

[FN20]. Prior to the Tax Reform Act of 1986, the highest marginal corporate tax rate was 46%. For a corporation in the highest bracket, only 54 cents remained of each dollar earned after payment of corporate income taxes. If the after-tax income was distributed as a dividend to shareholders, shareholders in the highest marginal bracket paid 50%, or 27 cents, of the dividend in individual income taxes. Thus, of the dollar earned and distributed to shareholders, Uncle Sam received 46 cents for corporate income taxes and 27 cents for individual income taxes, or a total of 73 cents.

[FN21]. I.R.C. § 1 (1982).

[FN22]. Effective in 1988 the highest marginal corporate tax rate is 34%. For a corporation in the highest bracket, 66 cents remains of each dollar earned after payment of corporate income taxes. If the after-tax income is distributed as a dividend to shareholders, shareholders in the highest marginal bracket will pay 28%, or 18.48 cents, of the dividend in individual income taxes. Thus, of the dollar earned and distributed to shareholders, Uncle Sam receives 34 cents for corporate income taxes and 18.48 cents of individual income taxes, or a total of 52.48 cents.

[FN23]. Tax Reform Act of 1986, Pub. L. No. 99-514, § 601(a), 100 Stat. 2085 (1986).

[FN24]. *Id.* at § 101(a), 100 Stat. 2085.

[FN25]. A qualified personal service corporation is defined in I.R.C. § 448(d)(2) (1986). Under this provision a qualified personal service corporation is a corporation (i) substantially all of the activities of which involve services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (ii) substantially all of the stock of which is held by employees, retired employees, or estates or devisees of employees or retired employees. *Id.*

[FN26]. I.R.C. § 11(b)(2) (1986).

[FN27]. The *General Utilities* doctrine arose out of the landmark case, General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). In *General Utilities*, the Supreme Court held that a corporation's distribution of appreciated stock of another corporation to its stockholders as a dividend did not generate taxable gain to the corporation. This case has been widely interpreted as standing for the proposition that no gain is recognized to the corporation upon corporate distributions of appreciated property to its shareholders. The principles of *General Utilities* were codified in I.R.C. §§ 311 and 336.

The *General Utilities* principles were also extended through the enactment of § 337, which permitted a corporation to avoid recognition of corporate level gain on the sale of appreciated property followed by a liquidation within twelve months, and through the special non-recognition provisions of I.R.C. § 338, which permitted the non-recognition of corporate level gain on the deemed sale of assets accompanying certain acquisitions of corporate stock.

[FN28]. Section 631(c) of the Tax Reform Act of 1986 repealed the codified *General Utilities* rule of § 311 and generally requires the recognition of gain or loss on a non-liquidating distribution of appreciated property by a corporation to its shareholders. In addition, § 631(a) of the Tax Reform Act of 1986 repealed the codified *General Utilities* rule of § 336 and generally requires the recognition of gain or loss on the distribution of appreciated property from a corporation to its shareholders upon liquidation of the corporation.

[FN29]. Sections 631(a) and (d) of the Tax Reform Act of 1986 also repealed the statutory provisions of I.R.C. § 337 which permitted a corporation to avoid recognition of corporate level gain on the sale of appreciated property followed by a liquidation within twelve months. In § 631(b) of the Tax Reform Act of 1986, Congress also repealed the special non-recognition provisions of I.R.C. § 338 which permitted the non-recognition of corporate level gain on the deemed sale of assets accompanying certain acquisitions of corporate stock.

[FN30]. I.R.C. § 1374 (1986) imposes a corporate level tax upon recognized ‘built-in gain’ of an S corporation. The term ‘built-in gain’ refers to the excess of the fair market value of an asset as of the beginning of the first year the corporation is an S corporation over the adjusted basis of such asset at that time. Under I.R.C. § 1374(d), built-in gain is only recognized if the asset is disposed of during the ‘recognition period,’ which is defined as the ten-year period beginning with the first day of the first Subchapter S taxable year. Thus, the sale of an asset after the first ten Subchapter S years does not result in the recognition of built-in gain.

[FN31]. Under I.R.C. § 1374(d)(2)(B) (1986), built-in gain is recognized upon sale only to the extent of the excess of the fair market value of the asset as of the beginning of the first Subchapter S taxable year over the adjusted basis in the asset at that time. Thus, subsequent appreciation avoids the built-in gain tax of § 1374.

[FN32]. Under I.R.C. § 1374 (1986), a built-in gain is recognized on the disposition of any asset unless such asset was not held at the beginning of the first taxable year the corporation was an S corporation. Since newly incorporated businesses have no assets at the beginning of their first year as S corporations, the built-in gain tax of § 1374 does not apply to these businesses.

[FN33]. Section 633(b) of the Tax Reform Act of 1986 provided that the amendments to I.R.C. § 1374 were effective only for S corporations whose first taxable year as an S corporation resulted from an election made after December 31, 1986. Thus, a conversion to Subchapter S pursuant to an election made prior to 1987, even if the election was not effective until a taxable year beginning in 1987, subjected the corporation to old § 1374 rather than to new § 1374. Under old § 1374, the tax imposed on certain excess net capital gains did not apply if the S corporation election had been in effect for the three immediately preceding taxable years.

[FN34]. Section 633(d) of the Tax Reform Act of 1986 imposed a special transitional rule for certain small corporations electing Subchapter S prior to 1989. Under these rules, sales generating ordinary gain or loss, short-term capital gain or loss, or gain to which § 453B applies, are subject to the new provisions of § 1374. Sales generating long-term capital gain, however, qualify for the transitional rule and thus are subject to old § 1374.

Under § 633(d)(8) of the Tax Reform Act of 1986, as amended by § 1006(g)(7) of the Technical and Miscellaneous Revenue Act of 1988, this transitional relief for certain small corporations applies to any corporation which makes an election to be an S corporation before January 1, 1989. Thus, any qualified corporation which converts to Subchapter S by an election filed in 1988 obtains transitional relief even if the election becomes effective on or after January 1, 1989.

[FN35]. I.R.C. § 1367(a)(1) (1986).

[FN36]. I.R.C. § 1367(a)(2) (1986).

[FN37]. Section 301(a) of the Tax Reform Act of 1986.

[FN38]. *See* Kafka & Hoenicke, *Reasonable Compensation*, 390 Tax Mgmt. Portfolios (BNA) at A-1 (1987); [1988] Stand. Fed. Tax Rep. (CCH) ¶1372; [1988] Fed. Taxes (P-H) ¶¶11,611-11,774. There have been so many unreasonable compensation cases decided that many statistical and tabular summaries of such case law have been prepared. *See* Kafka & Hoenicke, *Reasonable Compensation*, 390 Tax Mgmt. Portfolios (BNA) at A-12, ¶ IV.I.

[FN39]. *See* Modricker, *Real Estate Leases and Improvements*, 47-4th Tax Mgmt. Portfolios (BNA) at A-8 through A-11, ¶ II.C.2.b. (1986); [1988] Stand. Fed. Tax Rep. (CCH) ¶¶1382.554-.559; [1988] Fed. Taxes (P-H) ¶11,832.

[FN40]. *See* [1988] Stand. Fed. Tax Rep. (CCH) ¶1340; [1988] Fed. Taxes (P-H) ¶¶ 11,161-11,173.

[FN41]. If, however, the amount of the disallowed deduction exceeds the balance of the corporation's accumulated adjustments account, the adjustment could result in a deemed dividend of Subchapter C earnings and profits to the extent of this excess. Under I.R.C. § 1368(c) distributions of a former C corporation to its shareholders are first treated as coming out of the accumulated adjustments account of the corporation. To the extent the distributions are treated as coming out of the accumulated adjustments account, the distributions are not taxable to the recipient. However, to the extent the distributions exceed the balance of the accumulated adjustments account, the distributions are treated as distributions of Subchapter C earnings and profits under I.R.C. § 1368(C)(2).

However, there is authority for the proposition that the disallowance of a corporate deduction for compensation paid to a shareholder-employee does not change its character as compensation to the employee. In Sterno Sales Corp. v. United States, 345 F.2d 552, 554 (Ct. Cl. 1965), the Court of Claims stated:

> Compensation remains compensation even if it is held unreasonable in amount and, accordingly, not deductible as a business expense. The payment does not change in character solely because it is characterized as excessive or undue. The nondeductibility of the expense by the payor, because it is unreasonable in amount does not transform the payment in the hands of the payee.

This approach raises the specter that excessive compensation, rent, or similar items paid to a shareholder-payee may effectively be taxed in the same manner under Subchapter S as under Subchapter C. If the item is not treated as a dividend of Subchapter C earnings and remains taxable to the payee, the loss of the corporate deduction will result in double taxation of the payment under Subchapter S.

[FN42]. For instance, consider an S corporation owned 50% by shareholder A and 50% by shareholder B. If a payment of $50,000 to A was disallowed as a deduction and recharacterized as a dividend, the payment should be treated as a $25,000 dividend to A and a $25,000 dividend to B, followed by a transfer from B to A of $25,000. If A is in a lower tax bracket than B, the recharacterization of the expenditure as a dividend could increase the overall tax liability of A and B to the extent of the excess of B's marginal tax rate over A's marginal tax rate applied against the deemed dividend to B. In addition, the deemed transfer from B to A of $25,000 could result in gift tax consequences to B if the deemed transfer is regarded as a gift, since it would exceed B's annual gift tax exclusion.

[FN43]. Prior to the Tax Reform Act of 1986, the marginal individual income tax brackets ranged from 11% to 50%. After the Tax Reform Act of 1986, the marginal individual income tax brackets range from 15% to 28% (33% considering the additional tax under I.R.C. § 1(g) on certain ranges of income). Moreover, after the Tax Reform Act of 1986, the range of brackets for taxpayers having income above the break point at which the 28% tax bracket is reached is only from 28% to 33%. Prior to the Tax Reform Act of 1986, the range of brackets for taxpayers having income above such amount was considerably larger (from 25% to 50% for married taxpayers filing jointly, from 23% to 50% for single taxpayers).

[FN44]. Due to the compression of the tax rates, the reallocation of income will generate tax only by the amount of the rate differential of the affected taxpayers applied against the amount of the reallocation. To the extent these rates are compressed, the tax generated by the reallocation will be reduced accordingly.

[FN45]. I.R.C. §§ 531-537, Chapter 1G, Part I. The accumulated earnings tax imposes a tax on income accumulated beyond the reasonable needs of the business. This tax is designed to prevent corporations from avoiding double taxation of corporate earnings (and, prior to the Tax Reform Act of 1986, to prevent the avoidance of tax at individual rates higher than corporate rates) by the failure to distribute earnings which are not reasonably needed by the business.

Section 1001(a)(2)(A) of the Technical and Miscellaneous Revenue Act of 1988 eliminated the graduated tax rates under the accumulated earnings tax. For tax years beginning after December 31, 1987, accumulated earnings tax is imposed at the rate of 28% of accumulated taxable income. Prior to this amendment the accumulated earnings tax was imposed at the rate of 27 1/2% for the first $100,000 of accumulated taxable income and 38 1/2% for accumulated taxable income in excess of $100,000.

[FN46]. I.R.C. §§ 542-547, Chapter 1G, Part II. The personal holding company tax is imposed on certain closely held corporations which derive most of their income from dividends, rents, royalties, and personal service contracts. This tax was originally imposed to prevent the use of a corporation to shelter personal investment income from high individual income tax rates. Due to the rate inversion effectuated by the Tax Reform Act of 1986, there is no longer any significant benefit to be obtained by having investment income taxed to a corporation rather than to an individual.

Personal holding company tax is imposed at the rate of 28% of the undistributed personal holding company income.

[FN47]. I.R.C. § 1363(a) (1986).

[FN48]. The accumulated earnings tax is imposed at the rate of 28% on accumulated taxable income. The personal holding company tax is imposed at the rate of 28% of the undistributed personal holding company income. These taxes are particularly onerous since they are in addition to the regular corporate income tax and the income subject to the tax remains subject to individual income tax when it is ultimately distributed to shareholders.

[FN49]. I.R.C. § 1375 (1986).

[FN50]. I.R.C. § 1362(d)(3) (1986).

[FN51]. Notably, however, the personal holding company tax is imposed if more than 60% of a corporation's adjusted gross income consists of personal holding company income. The tax on excess passive investment income of an S corporation, on the other hand, only applies if more than 25% of the corporation's gross receipts are passive investment income receipts. Thus, since the receipts of a business are typically much higher than the adjusted gross income generated from such receipts, it is quite possible for a corporation to be subject to the personal holding company tax though it has enough business receipts to avoid the tax on excess passive investment income.

A corporation having personal holding company problems may benefit from a Subchapter S election even if the corporation will be subject to the tax on excess passive investment income, since the personal holding comapny tax is imposed on all personal holding company income, while the tax on excess passive investment income is imposed only on net passive income in excess of a specified limit. Moreover, even if a corporation is subject to the tax on excess passive investment income, in most years the corporation can avoid termination of the S election if it can avoid imposition of the tax in any three consecutive years.

The question of whether a corporation experiencing personal holding company problems can benefit from a Subchapter S election is a particularly complex one, since the items making up personal holding company income are not the same as those comprising passive investment income. A corporation having personal holding company problems must carefully analyze expected future sources of income and receipts to determine whether Subchapter S will benefit it.

[FN52]. For instance, consider a C corporation having $50,000 of tax preferences and no taxable income. Such a corporation would pay alternative minimum tax on $10,000, the excess of alternative minimum taxable income ($50,000) over the corporate exemption amount ($40,000). A sole shareholder of a similar S corporation who had $100,000 of other income and who filed as a married taxpayer filing jointly would have no alternative minimum tax. Such a shareholder's tentative minimum tax would be imposed on the excess of his alternative minimum taxable income ($150,000) over his exemption amount ($40,000). Since his tentative minimum tax ($110,000 x 21% = $23,100) is less than his regular tax ($25,537.50 on $100,000 of taxable income), no alternative minimum tax is imposed. If the corporation has many shareholders, it becomes even less likely that individual alternative minimum tax will be imposed, due to the availability of numerous exemption amounts which can be set off against any passed-through tax preferences, unless all or part of a shareholder's exemption amount is phased out under I.R.C. § 55(d)(3).

While in some cases a Subchapter S conversion reduces the prospect of alternative minimum tax, it may be made more likely if the corporation is an S corporation than if it is a C corporation depending on the tax circumstances of the corporation and its shareholders. *See infra* III.G. and example at note 105.

[FN53]. For instance, consider a corporation having book income of $200,000 but no taxable income, due solely to the receipt of tax-exempt income (other than interest from specified private activity bonds treated as a tax preference for both individuals and corporations under I.R.C. § 57(a)(5)). Under the adjusted book income preference of § 56(f) applicable to C corporations, 50% of the excess of book income over taxable income is treated as a tax preference item. As a result, alternative minimum taxable income of such a corporation would be $100,000 ($0 + (50% x $200,000) = $100,000). Corporate alternative minimum tax would be imposed on the excess of this amount over the exemption, resulting in alternative minimum tax of $12,000 (($100,000 - $40,000) x 20% = $12,000). Since the tax-exempt interest is not a preference item to an individual, receipt of such interest by an S corporation would not result in the imposition of alternative minimum tax to the shareholders.

[FN54]. I.R.C. § 1(i) (1986). Under § 6006 of the Technical and Miscellaneous Revenue Act of 1988, under certain circumstances a parent may elect simply to include the unearned income of a dependent child on the parent's return for years after 1988.

[FN55]. *See supra* § II.F.

[FN56]. I.R.C. § 1366(e) (1986).

[FN57]. Borhowski v. Commissioner, 43 T.C.M. 593 (1982); Werner v. Commissioner, 47 T.C.M. 1414 (1983); Holn v. Commissioner, 46 T.C.M. 233 (1983).

[FN58]. I.R.C. §§ 469(a) and (d) (1986).

[FN59]. I.R.C. § 1366(b) (1986); I.R.C. § 469(c)(1) (1986).

[FN60]. I.R.C. § 469(e)(1)(A)(i)(I) (1986).

[FN61]. Under I.R.C. §§ 448(b)(1) and (2) (1986), farming businesses and personal service corporations are excepted from the requirement of using the accrual method of accounting, unless the business is a tax shelter as defined in I.R.C. § 461(i)(3) (1986).

[FN62]. By its terms, § 448 applies only to C corporations, partnerships which have a C corporation as a partner, and tax shelters.

[FN63]. I.R.C. § 471 requires businesses carrying inventories to use an inventory method of accounting if the IRS believes it necessary in order to clearly reflect income. Businesses carrying inventories are also generally required to adopt the accrual method of accounting with respect to purchases and sales in order to clearly reflect income under Treas. Reg. § 1.446-1(c)(2) (1986).

[FN64]. Certain personal service corporations are not required to use the accrual method of accounting regardless of the amount of annual revenues under I.R.C. § 448(b)(2) (1986). The definition of a 'qualified personal service coproration' eligible for this exception from the general requirement of using accrual accounting is set forth in I.R.C. § 448(d)(2) (1986) and is the same definition applicable under § 11(b) in determining whether lower corporate rate brackets are available. This absence of the accrual accounting requirement for such corporations was apparently the trade off in the Revenue Act of 1987 for requiring such corporations to have all of their income taxed at the highest marginal corporate rates.

Since qualified personal service corporations are never required to use the accrual method of accounting, a Subchapter S election does not benefit such a corporation by avoiding the requirement. However, since such a corporation is required to pay tax at the highest marginal bracket as a C corporation under § 11(b), such a corporation will always benefit from a Subchapter S conversion due to the rate inversion brought about by the Tax Reform Act of 1986.

[FN65]. I.R.C. § 446(e) (1986) specifically provides that a taxpayer must obtain the Commissioner's consent before changing its method of accounting for federal income tax purposes.

[FN66]. *See* Holman, Diamond & Oshinsky, *Accounting Methods-Adoption and Changes*, 303-4th Tax Mgmt. Portfolios (BNA) § IV.B.3.a. (1986). *See also* Rev. Proc. 84-74, 1984-2 C.B. 736, at § 4.05.

[FN67]. The IRS is also given broad latitude to impose those terms and conditions on a change of accounting method which it deems necessary to clearly reflect income. *See* Rev. Proc. 84-74, 1984-2 C.B. 736, at § 2.01.

In addition, adjustments under I.R.C. § 481 accompanying a change of accounting method may have a substantial adverse impact on the taxpayer which may limit the benefits of a conversion to the cash method of accounting. Under I.R.C. § 481(c) (1986), the IRS is given broad authority under regulations to specify how adjustments due to a change in accounting method are taken into account by the taxpayer.

[FN68]. Income in excess of $75,000 is taxed at a rate of 34% or above; income of $75,000 to $100,000 is taxed at 34%; income of $100,000 to $335,000 is taxed at 39%; income in excess of $335,000 is again taxed at the 34% rate. I.R.C. § 11(b) (1986).

[FN69]. *Id.*

[FN70]. *See supra* § II.F.

[FN71]. I.R.C. § 11(b)(2) (1986) (as amended by Revenue Act of 1987).

[FN72]. PRENTICE-HALL, ALL STATES TAX GUIDE ¶223 (Oct. 20, 1987). Iowa and Montana use only the sales factor. Connecticut, Minnesota, Mississippi, and Nebraska use only the sales factor when apportioning the income of certain types of businesses. Colorado uses only the property and sales factors. Various states use variations of their basic apportionment formulas for specialized types of businesses.

[FN73]. IOWA CODE § 422.33(2)(b)(4) (1987).

[FN74]. Twenty-five states and the District of Columbia indicated in response to a *Multistate Corporate Tax Almanac* survey that they had a throwback rule. Nineteen states indicated that they did not have a throwback rule. Two states did not respond, and four states have no corporate income tax. Iowa has no throwback rule.

Of those states with no throwback rule, only one state, Montana, indicated that the denominator of the apportionment fraction was reduced by the out-of-state apportionment factors which were not taxed in other jurisdictions. A. RAABE, MULTISTATE CORPORATE TAX ALMANAC 247-56 (1988).

[FN75]. Since Iowa has no throwback rule and since the denominator of the apportionment fraction is not reduced by out-of-state sales which are not subject to corporate income tax in foreign states, the income apportioned to Iowa is based solely on the ratio of sales in Iowa to total sales worldwide.

[FN76]. PRENTICE-HALL, ALL STATES TAX GUIDE ¶222-C (Oct. 20, 1987). In all, thirty-eight states adopt a pass-through system similar to that adopted by federal law, for taxation of the income of S corporations. In most cases, state law provides specifically that non-resident shareholders are liable for state income tax on their share of corporate income apportioned to the state. Alternatively, the corporation may be required to withhold or pay state income taxes on income of non-resident shareholders.

Arkansas, Indiana, Mississippi, New York, Pennsylvania, and Wisconsin require the corporation to make a separate state election to be taxed as an S corporation for state income tax purposes. If such an election is not filed, the corporation is taxed as a regular corporation. Montana and Ohio also require filing of a copy of the federal S corporation election.

While the vast majority of states tax S corporations in the same general manner as the federal law does, there are nevertheless differences in taxation of S corporations among these states. Different states handle the taxation of S corporation built-in gains, capital gains, and excess passive income in different ways. In addition, these states differ concerning the modifications to corporate and shareholder income, the determination of shareholder state tax basis in S corporation stock, and the method of calculating the accumulated adjustments account. *See*, DRAFT MODEL S CORPORATION STATE INCOME TAX ACT (Subcommittee on State Taxation of the S Corp. Comm. of the Am. Bar Ass'n Section of Taxation, Aug. 1988).

[FN77]. PRENTICE-HALL, ALL STATES TAX GUIDE ¶222-C (Oct. 20, 1987). States taxing S corporations as regular corporations are Connecticut, Louisiana, Michigan, New Hampshire, New Jersey, North Carolina, and Tennessee. The District of Columbia also taxes S corporations as regular corporations.

Although the Prentice-Hall guide lists Vermont as a state which taxes S corporations as regular corporations, Vermont only taxes S corporations on Vermont income of non-resident shareholders. It adopts the federal method for resident shareholders. Thus, Vermont is more properly regarded as recognizing the S election.

[FN78]. PRENTICE-HALL, ALL STATES TAX GUIDE ¶222-C (Oct. 20, 1987). Nevada, South Dakota, Texas, Washington, and Wyoming have no state income tax.

[FN79]. *E.g.*, the District of Columbia taxes dividends received by a resident shareholder of an S corporation. Taxpayer Serv. of D.C. Dep't of Fin. & Revenue, personal communication (Dec. 20, 1988).

[FN80]. There are variations among the states as to whether the corporate or the individual apportionment formula is employed with respect to income from an S corporation. *See* DRAFT MODEL S CORPORATION STATE INCOME TAX ACT, *supra* note 76.

[FN81]. The hypothetical business having 5% of its sales within a state will arrive at the same result, if that state has a throwback rule. Due to the application of the throwback rule, 100% of such a corporation's income will be taxed in the state in which the corporation resides despite the general provisions of the state's apportionment formula.

[FN82]. Since the tax is paid by the corporation and the taxpayer is an individual, the credit in this situation must be explicitly granted by statute in order to be allowable. DRAFT MODEL S CORPORATION STATE INCOME TAX ACT, *supra* note 76, commentary at 3. The Model Act would provide for a credit in this situation.

[FN83]. Additional problems arise due to differing Subchapter S qualification requirements, differing methods of determining corporate income, and questions as to the applicability of credits for taxes paid to other states. For a complete discussion of these problems, *see* Maule, *Effect of State Law on the Use of S Corporations*, 37 TAX LAW. 535 (Spring 1984).

[FN84]. Section 632(a) of the Tax Reform Act of 1986.

[FN85]. I.R.C. § 1374(d)(3) (1986).

[FN86]. I.R.C. § 1374(b) (1986).

[FN87]. I.R.C. § 1374(d)(1) (1986).

[FN88]. Telephone calls to the principal drafter of the regulations under § 1374 during 1988 reveal some dispute within the IRS as to the proper handling of this matter. According to the principal drafter, some within the IRS take the position that, since net operating losses from C years can be used against recognized built-in gains under I.R.C. § 1374(b)(2), inventory should be valued for purposes of the tax on built-in gains at its retail value at the effective date of the S election. Prior to enactment of the Technical and Miscellaneous Revenue Act of 1988, the IRS had sought enactment of a limitation on the use of net operating losses from C years against built-in gains as a quid pro quo for refraining from issuing regulations which would mandate the use of a retail method of valuing inventory for purposes of the tax on built-in gains. However, the provision which would have limited the use of C year net operating losses against built-in gains was not enacted in the Technical and Miscellaneous Revenue Act of 1988. Despite the failure of Congress to enact the provision sought by the IRS, and despite the philo-sophical concern of certain individuals within the IRS, in a recent telephone call the principal drafter of the regulations under § 1374 indicated that he thought that the regulations would probably not mandate a retail method of valuing inventory for purposes of the tax on built-in gains. However, the issue is not yet settled. The principal drafter expects that the regulations under new § 1374 will be issued in February or March of 1989.

[FN89]. Announcement 86-128, 1986-51 I.R.B. 22.

[FN90]. LIFO refers to the 'last-in-first-out' method of calculating inventories. Under this method, sales of inventory are deemed to be sales of the inventory most recently produced or purchased, and inventory is credited accordingly based upon the cost of the inventory recently purchased. FIFO refers to the 'first-in-first-out' method of calculating inventories. Under this method, sales of inventory are deemed to be sales of the oldest inventory, and upon a sale of inventory it is credited based upon the cost of the oldest inventory.

The LIFO method tends to increase the cost of goods sold and consequently reduces taxable income in periods during which inventory costs are rising.

[FN91]. Corporations should be wary of changing their method of accounting from FIFO to LIFO in anticipation of a conversion to Subchapter S. The Senate's version of the Revenue Act of 1987 included a provision broadening the delegation of authority to the Treasury Department to issue regulations under § 337(d) to prevent circumvention of the corporate tax on distributions of appreciated property. Revenue Amendments of 1987, § 6666(e)(5). The Senate Finance Committee Report stated as follows with respect to this provision:

> It is also expected that the Treasury Department will prevent the manipulation of accounting methods or other provisions that may have the result of deferring gain recognition beyond the 10 year recognition period-for example, in the case of a C corporation with appreciated FIFO inventory that converts to S status and elects the LIFO method of accounting.

SENATE COMM. ON THE BUDGET, REPORT ON RECONCILIATION SUBMISSIONS OF THE INSTRUCTED COMMITTEES PURSUANT TO THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1988, S. REP. NO. 76, 100th Cong., 1st Sess., *reprinted in* [1987] 44 Stand. Fed. Tax Rep. (CCH) (Extra Ed. Nov. 5, 1987). While the provision in the Senate bill was not adopted in the Revenue Act of 1987, the IRS may be reluctant to permit a change from FIFO to LIFO in the method of accounting for inventories on the basis that such a change would permit circumvention of the built-in gains tax of § 1374 and that therefore the new method would not clearly reflect income.

[FN92]. I.R.C. § 1363(f) (1986) (as amended by Tax Revenue Act of 1987).

[FN93]. I.R.C. § 1363(f)(2) (1986) (as amended by Tax Revenue Act of 1987). Section 2004(n) of the Technical and Miscellaneous Revenue Act of 1988 provides that, if the corporation was a member of an affiliated group for its last year as a C corporation, only the corporation electing Subchapter S is liable for any tax attributable to the recognition of the LIFO recapture amount.

[FN94]. I.R.C. § 1371(b)(1) (1986).

[FN95]. I.R.C. § 1374(b)(3) (1986).

[FN96]. I.R.C. § 1371(b)(1) (1986). While carryforwards are usually the carryovers focused on in this context, the provision also applies to carrybacks.

[FN97]. C corporations other than personal service corporations having more than half the value of their stock held directly or indirectly by five or fewer individuals qualify for this special rule. I.R.C. §§ 469(e)(2)(A), 469(j)(1), 465(a)(1)(B), 542(a) (1986).

[FN98]. I.R.C. § 469(e)(2) (1986).

[FN99]. I.R.C. §§ 234(a)(2) and (3) (1986).

[FN100]. I.R.C. § 243(a)(1) (1986).

[FN101]. I.R.C. § 244 (1986).

[FN102]. I.R.C. § 245 (1986).

[FN103]. *See supra* § III.F.

[FN104]. *See supra* § II.G and examples *supra* notes 52-53.

[FN105]. For instance, consider a C corporation having $50,000 of tax preferences and $100,000 of taxable income. Such a corporation would pay no alternative minimum tax because the tentative minimum tax (($150,000 - $40,000) x 20% = $22,000) does not exceed the regular corporate income tax ($22,250 on $100,000 of taxable income). A sole shareholder of a similar S corporation who had $100,000 of other income and $30,000 of other tax preferences and who filed as a married taxpayer filing jointly (having no other dependency exemptions) would be subject to alternative minimum tax. Such a shareholder's tentative minimum tax would be imposed on the excess of his alternative minimum taxable income ($100,000 + $150,000 + $30,000 = $280,000) over his exemption amount (only $7,500 due to the phase-out of the exemption for high income taxpayers under § 55(d)(3)). Thus, alternative minimum tax would apply because tentative minimum tax (($280,000 - $7,500) x 21% = $57,225) would exceed regular income tax ($57,092 on taxable income of $200,000).

Note that the facts above are the same as those set forth in note 52, *supra*-in which alternative minimum tax would be imposed under Subchapter C but not under Subchapter S-with only two changes. First, the corporation had taxable income of $100,000 in this example and none in the example in note 52. Second, the taxpayer had $30,000 of other tax preferences in this example, but he had no other tax preferences in the example in note 52. In other words, imposition of alternative minimum tax may become either more or less likely after an S conversion, depending on the particular facts involved. To make the determination, an analysis of the application of the alternative minimum tax under both Subchapter C and Subchapter S must be made, based upon the projected incomes and tax preferences of the corporation and its shareholders.

[FN106]. Such tax preferred fringe benefits include group-term life insurance, medical insurance, and disability insurance.

[FN107]. I.R.C. § 162(a)(1) (1986).

[FN108]. I.R.C. §§ 79, 106 (1986).

[FN109]. I.R.C. § 1372 (1986).

[FN110]. I.R.C. § 79 refers to group-term life insurance on the life of an employee. I.R.C. § 106 excludes coverage under an accident or health plan from the income of an employee.

[FN111]. Since the enactment of the Subchapter S Revision Act of 1982, the effect of the payment of fringe benefits to 2% shareholder-employees is unclear. The confusion relates to the interrelationship of the fringe benefit provisions, § 1372, and the partnership provisions of the Code.

Fringe benefits paid for partners of partnerships are not deductible under I.R.C. § 162, since such expenditures are only deductible if paid for employees and partners are not considered employees of a partnership. Instead, such payments constitute the payments of personal expenses of the partners, which are not deductible to the partnership by virtue of § 262. Consequently, these benefits are not deductible by an S corporation when paid to 2% shareholder-employees by virtue of § 1372, and they do not reduce the income of the corporation taxed to shareholders under § 1366.

At the same time, the cost of these benefits should be included in the income of the 2% shareholder for whom they are paid, since they do not qualify for exclusion under § 79 and § 106. However, I.R.C. § 1366 does not provide for any reduction in the amount of corporate income passed through to shareholders by virtue of the inclusion of the cost of these benefits in the income of the 2% shareholder-employee. Thus, these provisions could result in the inclusion of the cost of the benefits in both the income of the 2% shareholder-employee (by virtue of the non-applicability of § 79 and § 106) and in the income of all S corporation shareholders on a pro rata basis, since § 1366 makes no provision for reducing the corporate income allocated to shareholders by virtue of the inclusion of the cost of these benefits in the income of the 2% shareholder-employee.

It appears that Congress did not intend to subject these fringe benefits to double taxation, even though it included them in both the income of the 2% shareholder-employee and in the income of all shareholders on a pro rata basis under § 1366. The best way to resolve this obtuse statutory construction issue is to include the cost of the benefits in the income of the 2% shareholder-employee as a guaranteed payment under § 707(c). As guaranteed payments, the payments would then become deductible as § 162 deductions. They would then reduce the income taxed to shareholders under § 1366. This approach would result in the inclusion of the benefits in the income of the 2% shareholder-employee, but the same benefits would not be included in the income of all corporate shareholders under the Subchapter S pass-through of corporate income.

This approach gains indirect support from Treas. Reg. § 1.707-1(c) (1983) which states that a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from income under I.R.C. § 105(d). This regulation apparently contemplates that amounts paid under accident and health plans may be deductible as guaranteed payments. Therefore by analogy amounts paid for insurance under such plans should be deductible in a similar fashion. *See also* Starr, *S Corporations*, 60-7th Tax Mgmt. Portfolios (BNA) at 103 (1986), suggesting this approach.

The only difficulty with this approach is that § 1372 provides that 2% shareholder-employees are treated as partners only for purposes of applying the provisions of the Code relating to employee fringe benefits. Since § 707(c) is not a fringe benefit provision as such, the guaranteed payment provisions of § 707(c) may not apply in this context. Clarification of this issue will have to await the issuance of regulations by the Treasury Department under § 1372.

Pending issuance of regulations under § 1372, the advisable route would seem to be to issue a W-2 to the 2% shareholder-employee for the cost of such benefits, and have the corporation deduct this cost as compensation. This deduction then reduces the income of the corporation which flows through to the corporation's shareholders under § 1366.

[FN112]. I.R.C. § 162(m) (1986), added by § 1161 of the Tax Reform Act of 1986, permits a self-employed person to deduct 25% of the cost of health insurance for himself and his dependents. This deduction is only allowable for payments under plans meeting the requirements of I.R.C. § 89. It does not apply if the taxpayer is eligible to participate in any subsidized health plan maintained by any other employer of the taxpayer or of the taxpayer's spouse. The amount of the deduction is limited to the taxpayer's earned income from the trade or business with respect to which the plan is established. I.R.C. § 162(m)(2)(A) (1986); Technical and Miscellaneous Revenue Act of 1988 § 1011B(b).

While the amount paid by an employee of a C corporation for health insurance is deductible, it is an itemized deduction and is additionally subject to a floor on deductibility. Under § 213 these amounts are deductible as an itemized deduction by an employee only to the extent that the amount paid plus amounts paid for medical and dental care exceeds 7.5% of the employee's adjusted gross income. As a result of this floor on the deductibility of such expenses, many shareholder-employees will receive no tax benefit from the § 213 deduction.

On the other hand, the partial deduction for health insurance coverage for 2% shareholder-employees of S corporations is not subject to a deductibility floor. Hence it will be deductible without regard to the amount of the employee's adjusted gross income or the amount of other medical expenses paid during the year. In addition, the partial deduction is an above-the-line deduction, taken in calculating adjusted gross income, rather than a below-the-line itemized deduction deductible only to the extent that itemized deductions exceed the standard deduction. As a result, the partial deduction provided by § 162(m) will in most cases be a benefit gained by 2% shareholder-employees of S corporations which was not available when the corporation was a C corporation.

Thus, while the exclusion from income of the *employer provided portion* of such coverage is lost under Subchapter S, a partial deduction of the *entire amount expended* for such coverage is gained. If the employer requires employees to pay a substantial portion of the cost of health insurance coverage, the loss of the corporate deduction by Subchapter S conversion may be offset by the employee's newly gained deduction.

[FN113]. I.R.C. § 4975(d)(1) (1986). To avoid the prohibited transaction rules, loans must: (1) be available to all participants on an equivalent basis, (2) not be made available to highly compensated employees in amounts greater tnan those made available to other employees, (3) be made in accordance with plan provisions, (4) bear a reasonable rate of interest, and (5) be adequately secured.

[FN114]. The final paragraph of I.R.C. § 4975(d) (1986) provides that the exemption from the prohibited transaction rules does not apply to plans lending money to owner-employees. This provision further specifies that the term 'owner-employee' includes a shareholder-employee as defined in § 1379 immediately prior to its amendment by the Subchapter S Revision Act of 1982. Section 1379(d), as in effect immediately prior to the Subchapter S Revision Act of 1982, defined a shareholder-employee as an employee or officer of an S corporation who owned or was deemed to own under the § 318 attribution rules 5% or more of the outstanding stock of an electing small business corporation on any day during the taxable year.

[FN115]. Advisory Opinion 84-44A (Nov. 9, 1984) held that a participant loan which is not excepted from being treated as a prohibited transaction becomes a prohibited transaction as of the effective date of the Subchapter S election. Thus, such loans must generally be repaid prior to the effective date of the Subchapter S election.

[FN116]. Section 1898(i) of the Tax Reform Act of 1986 amended ERISA § 408(d) to permit an owner-employee to request an administrative exemption from the Department of Labor for certain prohibited transactions, including participant loans.

[FN117]. I.R.C. § 401(a)(13) (1986) provides that a trust is not a qualified trust unless it prohibits the assignment or alienation of plan benefits. This section further provides that no assignment or alienation is deemed to exist with respect to a participant loan exempt from the prohibited transaction rules. Thus, if no administrative exemption to the prohibited transaction rules is obtained, the assignment of a 2% shareholder-employee's plan benefit as security for a participant loan would constitute a prohibited assignment or alienation and the trust would not meet the plan qualification provisions of § 401(a)(13).

[FN118]. Tax Reform Act of 1986, P.L. 99-514, § 1101(b)(2)(B).

[FN119]. I.R.C. § 72(p)(3) (1986). Under this provision the interest is non-deductible even if the loan proceeds are used for business purposes or the loan is secured by a mortgage on the taxpayer's principal residence. Thus, the disallowance of the deduction under this section supersedes those provisions of the Code which would otherwise allow the deduction.

[FN120]. I.R.C. § 416(i)(1)(A)(iii) (1986). *See also* I.R.C. § 416(i)(1)(B)(i)(I) (1986).

[FN121]. The provisions of I.R.C. § 72(p)(2) (1986), which provides an exception from the general rule that qualified plan loans are treated as taxable distributions if certain requirements are met, was amended in several respects in the Tax Reform Act of 1986 to restrict qualified plan borrowings. First, a new provision was enacted requiring such loans to be put on a level payment amortization, with payments to be made no less frequently than quarterly. Second, the exception to the requirement that a plan loan must be repaid within five years for home acquisition or improvement loans was limited to loans for the acquisition of a principal residence. Third, the amendment provided that the $50,000 overall limit on such loans is to be reduced by any reductions in plan loans during the one-year period preceding the date of the loan. These revisions have reduced the relative attractiveness of the use of qualified plan loans.

[FN122]. However, a corporation's tax return preparation has been complicated considerably by the amendments to the alternative minimum tax under the Tax Reform Act of 1986. Corporations now have a tax preference item tied to the adjusted book income or earnings and profits of the corporation. By virtue of this tax preference item for C corporations, such corporations must perform a separate reconciliation to determine the amount of this tax preference item. S corporations do not have to perform this reconciliation. In some cases, the complexity of this computation will make the conversion to Subchapter S more palatable and the corporate tax return simpler.

[FN123]. I.R.C. § 1377(a)(1) (1986).

[FN124]. Under I.R.C. § 1378 (1986), S corporations are generally required to use a calendar year unless a fiscal year can be justified to the satisfaction of the IRS on the basis of a business purpose.

However, I.R.C. § 444 (added by § 10206(a)(1) of the Revenue Act of 1987) provides that an S corporation may elect to use a fiscal year ending in October or November even in the absence of a business purpose for such a year if the corporation makes the payments required by I.R.C. § 7519. Under § 2004(e)(12) of the Technical and Miscellaneous Revenue Act of 1988, the election under I.R.C. § 444 terminates upon termination of the Subchapter S election. These provisions permit an S corporation limited flexibility in the choice of a fiscal year while preventing the corporation from deferring the payment of income taxes on income earned between the end of the fiscal year and the end of the calendar year in which the fiscal year end falls.

The required change to a calendar year, or even a fiscal year ending in October or November under § 444, can result in a substantial tax cost of converting to Subchapter S for some corporations. If the corporation has high income in the short tax period resulting from the conversion to Subchapter S, and losses in the other months of its existing tax year, the conversion to Subchapter S can result in substantial additional tax liability in the year of the conversion, by comparison with the taxes which would otherwise have been payable.

[FN125]. I.R.C. § 1361(b)(1)(A) (1986).

[FN126]. I.R.C. § 1361(b)(1) (1986).

[FN127]. I.R.C. § 1361(b)(2) (1986).

[FN128]. Economic Recovery Tax Act of 1981; Tax Equity and Fiscal Responsibility Act of 1982; Subchapter S Revision Act of 1982; Deficit Reduction Act of 1984; Tax Reform Act of 1986; Revenue Act of 1987; Technical and Miscellaneous Revenue Act of 1988.

[FN129]. *See supra* § II.I.

[FN130]. *See supra* § III.C.

[FN131]. I.R.C. § 1362(d)(1) (1986) permits a corporation to revoke its S election at any time upon the consent of shareholders holding more than one-half of the shares of stock of the corporation effective on the first day of the corporation's tax year (either preceding the revocation or subsequent to the revocation). Thus, if Subchapter S becomes adverse, the election can always be terminated. Of course, if the S election is terminated, the corporation cannot reelect Subchapter S status for five years under I.R.C. § 1362(g) (1986) without the prior consent of the IRS.

[FN132]. *E.g.*, T. D. NICHOLS & D. C. COOK, THE S VS. C DECISION MAKER (Aardvark, BNA) (computer software).
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