



Small Business Job Protection Act Eases S Corporation Rules

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The Small Business Job Protection Act of 1996 (the "Act"), signed into law on August 20, 1996, makes many changes to the rules under subchapter S of the Internal Revenue Code (the "Code"). In general, these changes have increased the flexibility of S corporations by easing the eligibility and operational requirements of S corporations. The following changes are effective for taxable years beginning after December 31, 1996, unless otherwise noted:

S Corporation Shareholders

S corporations may have up to 75 shareholders. Act § 1301.

The maximum number of eligible shareholders in an S corporation is increased from 35 to 75.

Electing small business trusts allowed to be S corporation shareholders. Act § 1302.

Grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may be shareholders in an S corporation. The Act expands this list to include "electing small business trusts." To qualify as such a trust, all beneficiaries of the trust must be individuals, estates or charitable organizations holding a contingent remainder interest. However, no interest in the trust can be acquired by purchase; interests in the trust must be acquired by gift, bequest or other non-purchase means. Each beneficiary of the trust is counted as a shareholder for purposes of the 75 shareholder limit.

This provision permits greater estate planning opportunities for S corporation shareholders by allowing trusts to be funded with S corporation stock.

Certain charities and qualified retirement plans allowed to be S corporation shareholders. Act § 1316.

The Act allows organizations exempt from tax under Code section 501(c)(3) and qualified retirement plans described in Code section 401(a) (collectively, "qualified tax-exempt shareholders") to own stock in an S corporation. However, **all** items of income or loss of an S corporation will flow through to qualified tax-exempt shareholders as unrelated business taxable income, regardless of the source or nature of that income. For example, an exempt, section 501(c)(3) shareholder's share of S corporation interest income is taxable even where that interest would not have been taxable if realized directly by the shareholder. This provision is effective for taxable years beginning after December 31, 1997.

Financial institutions permitted to hold safe harbor debt. Act § 1304.

An S corporation may not have more than one class of stock. Under the safe harbor provisions, certain debt ("straight debt") is not treated as a second class of stock. The Act expands the definition of straight debt to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

Basis of inherited S corporation stock is adjusted. Act § 1313.

The Act provides that any person who acquires stock in an S corporation through bequest, devise or inheritance must treat as income in respect to a decedent ("IRD") the *pro rata* share of any item of income of the corporation that would have been IRD if the income had been acquired directly from the decedent. The Act allows a deduction under Code section 691(c) for the estate tax attributable to an item of IRD. The stepped-up basis of the stock acquired from a decedent is reduced by that portion of the value of the stock attributable to items consisting of

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IRD. This provision applies with respect to decedents dying after August 20, 1996, the date of the enactment of the Act.

S Corporation Election and Terminations

Post-death qualification for testamentary trusts is expanded. Act § 1303.

The post-death holding period of S corporation stock for all testamentary trusts is expanded to 2 years (from 60 days).

The IRS may validate inadvertently defective elections. Act § 1305.

The Act allows the Internal Revenue Service (the "IRS") to validate inadvertently defective S corporation elections. The IRS will have the authority to waive the effect of an invalid election caused by an entity's inadvertent failure to qualify as a small business corporation or to obtain required shareholder consents, or both. The IRS also may treat late-filed S corporation elections as timely if reasonable cause exists. This provision applies to taxable years beginning after December 31, 1982.

Certain shareholders may elect to terminate year. Act § 1306.

Under Treasury regulations to be prescribed, the Act allows an S corporation and its "affected shareholders" to elect to terminate the taxable year of the S corporation upon the termination of any shareholder's interest. After such election is made, the closing of the S corporation's books applies only to the affected shareholders. "Affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom that terminating shareholder has transferred shares during the year.

Post-termination transition period is expanded and TEFRA audit procedures are repealed. Act § 1307.

The Act expands the definition of the 120-day post-termination period during which former S corporations may make potentially nontaxable distributions. The Act allows a former S corporation to make such distributions to shareholders during the 120-day period beginning on the date of any IRS audit adjustment of its S period income, loss or deduction after

termination of the S election. The Act also repeals the TEFRA partnership-based audit provisions.

Disallowed losses and deductions may be carried forward to post-termination period. Act § 1312.

The Act provides that losses disallowed under the at-risk rules of Code section 465 may be carried forward to the S corporation's post-termination period.

Re-election of S status for recent terminations is permitted. Act § 1317.

An S corporation that terminates its subchapter S election may not make another election to be an S corporation for five taxable years unless the IRS consents to the new election. The Act provides that for purposes of this five-year rule, any termination of a subchapter S election in a taxable year beginning before January 1, 1997 is not taken into account. Thus, any small business corporation that has terminated its S corporation within the five-year period immediately preceding August 20, 1996, the date of enactment, can re-elect subchapter S status without the IRS' consent. This provision is effective for terminations occurring in a taxable year beginning before January 1, 1997.

S Corporation Activities and Holdings

S corporations permitted to hold subsidiaries. Act § 1308.

The Act permits S corporations to own 80 percent or more of the stock of a C corporation. An S corporation, however, cannot elect to file a consolidated return with its affiliated C corporations. Dividends received by an S corporation from an 80 percent or greater owned C corporation will not be treated as passive investment income to the extent that the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

The Act also permits S corporations to own a qualified subchapter S subsidiary. A qualified subchapter S subsidiary includes any domestic corporation that qualifies as an S corporation and is wholly owned by an S corporation parent which elects to treat such subsidiary as a qualified subchapter S subsidiary. A qualified subchapter S subsidiary is not treated as a separate corporation. Accordingly, the assets, liabilities and items

of income, deduction, loss and credit of the subsidiary are treated as being those of the S corporation parent.

Certain financial institutions may be S corporations.
Act § 1315.

The Act allows a bank to elect to be treated as an S corporation if the bank does not use the reserve method of accounting for bad debts and is otherwise eligible to make an S election.

Tax-free liquidation of C corporation into an S corporation is allowed. Act § 1310.

The Act repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the Act clarifies that the subchapter C rules, including the tax-free liquidation provisions of Code sections 332 and 337, generally apply to the liquidation of a C corporation into an S corporation. The repeal of this rule does not change the general rule governing the computation of income of an S corporation.

S corporations may qualify for the capital gain presumption for real property subdivided for sale.
Act § 1314.

S corporations will be eligible for the capital gain presumption under the rules of Code section 1237 which apply to noncorporate taxpayers subdividing real estate for sale. Under Code section 1237 a parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land

being subdivided if certain conditions are satisfied. The Act extends this provision to land owned by S corporations.

S Corporation Distributions

Treatment of distributions during loss years is amended.
Act § 1309.

The Act provides that basis adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year. The Act also provides that for purposes of determining the accumulated undistributed account, the excess of losses and deductions over income for the taxable year is disregarded.

Certain earnings and profits are eliminated. Act § 1311.

The Act provides that the accumulated earnings and profits of an S corporation during its first taxable year beginning after December 31, 1995 will be reduced by any earnings and profits accumulated before January 1, 1983 and while the corporation was an S corporation. The elimination of those earnings and profits ensures that an S corporation's earnings and profits are attributable only to the taxable years during which its S election was not in effect.