April 10, 2013

The Honorable Max S. Baucus  
Chairman  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

The Honorable Dave Camp  
Chairman  
House Committee on Ways & Means  
1102 Longworth House Office Building  
Washington, DC 20515

The Honorable Orrin G. Hatch  
Ranking Member  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

The Honorable Sander Levin  
Ranking Member  
House Committee on Ways & Means  
1102 Longworth House Office Building  
Washington, DC 20515

Re: Options for Tax Reform in Subchapter S of the Internal Revenue Code

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform in Subchapter S of the Internal Revenue Code. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Rudolph R. Ramelli  
Chair, Section of Taxation

Charles H. Egerton  
Former Chair, Section of Taxation

Enclosure

cc:  Ms. Amber Cottle, Majority Staff Director, Senate Finance Committee  
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee  
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee  
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee  
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation  
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service  
Honorable Steven T. Miller, Acting Commissioner, Internal Revenue Service
OPTIONS FOR TAX REFORM
IN
SUBCHAPTER S
OF THE
INTERNAL REVENUE CODE

These options for tax reform (“Options”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”). The comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

These Options were prepared by members of the S Corporations Committee of the Section. Principal responsibility was exercised by John B. Truskowski, then Chair of the S Corporations Committee, and the following members of the S Corporations Committee: Thomas J. Phillips, John M. Carnahan III, C. Wells Hall, Kevin Simon and Stephen R. Looney. These proposals were reviewed by Kevin D. Anderson of the Section’s Committee on Government Submissions and by W. Curtis Elliott, Jr., Council Director for the S Corporations Committee.

Although the members of the Section who prepared these proposals have clients who are affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these Options.

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Date: April 10, 2013
EXECUTIVE SUMMARY

1. **Repeal excess passive income as a terminating event.** Under section 1362(d)(3)(A)(i)\(^1\), an S corporation election terminates whenever the corporation has accumulated earnings and profits ("E&P") at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25% of which is passive investment income. This Option would repeal section 1362(d)(3).

   This repeal would simplify the administration of S corporations. For S corporations which have passive investment income, the cost of monitoring such income to avoid the termination rules can be quite high and burdensome. There is also uncertainty in the definition of some of the items constituting passive investment income.

   The termination rule is also a trap for less sophisticated S corporations. In many cases where this issue arises, it may be too late to take corrective action, such as a dividend or deemed dividend to eliminate all of the S corporation’s E&P. Although inadvertent termination relief may be available under section 1362(f), that can be a lengthy and costly process, with additional monitoring costs being necessary going forward after reinstatement of the S corporation election.

2. **Repeal the tax on excess net passive income.** Section 1375(a) provides that if an S corporation has E&P at the close of a taxable year, and more than 25% of its gross receipts is passive investment income, then a corporate-level tax is imposed on its net passive income at the highest rate of tax specified in section 11(b).

   The primary purpose for making an S corporation election is to avoid the corporate level tax. Changes made by the Subchapter S Revision Act of 1982 were designed to encourage small business corporations to take advantage of Subchapter S and eliminate traps for the unwary. It is difficult to reconcile the tax on excess net passive income with these purposes.

   Without a clear rationale for continuing the tax on excess net passive income, we believe that its repeal simplifies Subchapter S, eliminates traps for the unwary, reduces the administrative and recordkeeping requirements for S corporations, and promotes use of Subchapter S and the economic growth of small business corporations, without an appreciable loss of revenue.

3. **Permit the S corporation election to be made with the federal tax return for the first year for which the election is to be effective.** A small business corporation may file an S corporation election at any time during the taxable year preceding the year for which the election is to be effective or during the year in which the election is to be effective, provided that it is filed not later than the 15\(^{th}\) day of the third month of that year. The Service may treat a late S corporation election as timely filed if the small business

\(^{1}\) References to a “section” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
corporation demonstrates reasonable cause. A small business corporation generally must request this relief through the private letter ruling process, including payment of the applicable user fee.

Permitting a small business corporation and its shareholders to elect to be an S corporation on the first tax return filed by the small business corporation advances several important policies underlying the Code: (i) simplification for taxpayers, (ii) simplification and reduction in administrative burdens for the Service, and (iii) increased efficiencies for both taxpayers and the Service.

4. **Allow a Basis Increase for Back-to-Back Loans Regardless of Source of Funds.** An S corporation shareholder may deduct her allocable portion of the S Corporation’s losses if the shareholder has sufficient basis in the S corporation’s stock or debt of the corporation to the shareholder. Where the shareholder borrows funds from a related party and then loans those funds to the S corporation, the Service and courts have found that a basis increase is only allowed if the shareholder has made an “actual economic outlay” in such a manner that the shareholder is “poorer in a material sense.” In general, these rulings and cases have tended to allow basis increases only if the funds loaned to the S corporation originally came from an unrelated party.

Allowing a basis increase for back-to-back loans, regardless of the source of the funds borrowed, would advance several important policies underlying the Code: (1) simplification for taxpayers; (2) providing certainty for taxpayers in an area of the law that is currently fraught with uncertainty; (3) removing a trap for unsophisticated taxpayers and the unwary; and (4) simplification and reduction in administrative burdens for the Service.

In June 2012 the Department of the Treasury issued Proposed Regulations that provide helpful guidance in clarifying when a shareholder is entitled to increase basis for indebtedness of the S corporation to such shareholder as a result of a back-to-back loan. The S Corporations Committee is providing comments to these regulations, which applaud these proposals, but also recommend some clarifications and additions. Because we believe that further clarification is needed, and because courts, in light of the substantial precedent requiring an “actual economic outlay” to increase a shareholder’s basis under section 1366(d)(1)(B), might not follow the regulations, even if finalized with the recommended clarifications, we believe the option of amending section 1366(d)(1)(B) suggested below would be helpful for purposes of clarification and simplification.
OPTION 1: REPEAL EXCESS PASSIVE INVESTMENT INCOME AS A TERMINATION EVENT

I. PRESENT LAW.

S Corporations – Generally.

An S corporation is a small business corporation which has elected to be taxed under Subchapter S. Unlike other corporations, an S corporation generally does not pay federal income tax at the corporate level. Instead, items of income, loss, deduction or credit are passed through to the shareholders of the S corporation in proportion to their stock ownership. Exceptions to this general rule are the section 1374 built-in gains tax and the section 1375 tax on excess net passive income, each of which is applied at the corporate level.

Termination of S Corporation Status in General.

Under section 1362(d), an S corporation election terminates (a) when it is revoked, (b) if the corporation ceases to be a small business corporation, or (c) where passive investment income of the corporation exceeds 25% of the gross receipts of the S corporation for three consecutive years and the S corporation has accumulated earnings and profits (“E&P”) at the close of each of those taxable years.

Termination Due To Excess Passive Investment Income.

Under section 1362(d), an S corporation election terminates whenever the corporation has E&P at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25% of which is passive investment income. Section 1362(d)(3)(B) through (C) define what is passive investment income and gross receipts. Generally, passive investment income consists of gross receipts derived from royalties, rents, dividends, interest and annuities. Under section 1362(d)(3)(A)(ii), a termination due to excess passive investment income is effective on the first day of the first taxable year beginning after the third consecutive year of excess passive investment income.

C corporations with E&P that have elected S corporation status are subject to this excess passive investment income termination rule. Corporations that have been S corporations from their incorporation are not generally subject to this excess passive investment income termination rule as such corporations do not usually have E&P. An exception applies where the assets of a C corporation with E&P are transferred to an S corporation in a transaction described in section 381(a).

The termination rule can be avoided by eliminating all of the E&P of the S corporation. Under section 1368(e)(3), an S corporation, with the consent of all its shareholders, can elect to have a distribution treated as a dividend paid first from E&P instead of the accumulated adjustments account. Also, under Regulation section 1.1368-1(f)(3), an S corporation can elect, with the consent of all its shareholders, to distribute all of its E&P through a deemed dividend. If the deemed dividend election is made, the deemed dividend is considered for all purposes of the
Code as if it were actually distributed to the shareholders, who are then deemed to have contributed the dividend back to the S corporation as a capital contribution on the last day of the S corporation’s taxable year.

In the event the S corporation election terminates because of excess passive investment income and the termination was inadvertent, the election may be reinstated under section 1362(f).

II. **REASONS FOR OPTION.**

Termination of the S corporation election due to excess passive investment income has been part of Subchapter S since its enactment in 1958, although it has changed substantially over the years. As originally enacted, the termination provision was in section 1372(e)(5), which provided in part:

An election under subsection (a) . . . shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account . . . only to the extent of gains therefrom).

Any termination was effective for the taxable year of the corporation in which its passive income exceeded the 20% threshold.

The legislative history provides little insight on the purpose of this provision, although the legislative history of subsequent legislation does. The Senate Report accompanying the original legislation simply notes that the election terminates if passive income exceeds the 20% threshold. Similarly, the Conference Report only notes that the S corporation election can be terminated in any one of several ways.

In 1966, section 1375(e)(5) was amended. A new subparagraph (A) continued the 20% threshold, although reference was made to “passive investment income.” A new subparagraph (B) added an exception for the first two years the S corporation election was in effect. As long as the passive investment income in each of those two years was less than $3,000 each year, the S corporation election would not terminate even if the passive investment income exceeded 20% of gross receipts. Lastly, a new subparagraph (C) defined passive investment income using the same language in section 1375(e)(5) as originally enacted in 1958.

The legislative history does not address the original purpose of the passive investment income limitation. The Senate Report only noted that the provision as originally enacted

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created hardship for small businesses starting up. Delay in beginning normal business operations could lead to passive investment income exceeding the 20% threshold.

The legislative history to an amendment adopted in 1970\(^7\) does provide some insight. This amendment added the following language to the end of section 1372(e)(5)(C):

Gross receipts derived from sales or exchanges of stock shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

The Senate Report\(^8\) noted: “When these provisions [Subchapter S] were first enacted, Congress determined to make them applicable only to operating businesses and not to businesses which received significant amounts of passive investment income.”\(^9\) It continued:

Probably the principal reason why this limitation on passive income was adopted was to reduce the incentive to incorporate one’s investment activities merely to obtain tax deferral benefits accorded to pension, profit-sharing, and similar plans. However, with the imposition by the Tax Reform Act of 1969 of the H.R. 10-type of limitation on pensions, etc., paid to a shareholder-employee of a subchapter S corporation, this reason for denying the subchapter S treatment for passive income has disappeared. Furthermore, elimination of the passive income limitation was included in the legislative proposals presented by the Treasury Department (both the 1968 and 1969 recommendations) to simplify subchapter S and to deal with a series of other problems, such as inadvertent terminations of elections.\(^10\)

The Senate Report concluded that it was appropriate to deal with the specific problem covered by the amendment now “rather than to await the longer period necessary for the complete examination of Subchapter S.”\(^11\)

The Subchapter S Revision Act of 1982\(^12\) significantly changed this provision. First, the termination provision for excess passive investment income was redesignated as section 1362(d)(3). Second, the provision was recast in its present form: The S corporation must have E&P and the passive investment income must exceed 25% of gross receipts for three consecutive years. Lastly, the termination is effective as of the first day of the taxable year immediately following the third consecutive year of excess passive investment income.

The purpose of this change is not entirely clear. The Senate Report\(^13\) stated:

\(^{9}\) Id. at 1.
\(^{10}\) Id.
\(^{11}\) Id. at 2.
The committee’s bill continues the ability of small business corporations to elect a single level shareholder tax on the corporate earnings and encourages the use of these rules by eliminating unnecessary traps that exist under present law. Also, the bill tries to prevent unwarranted benefits from arising by reason of a subchapter S election.\textsuperscript{14}

Nevertheless, with respect to passive investment income, the Senate Report stated:

However, in order to prevent a “bail out” of undistributed earnings and profits, the bill will continue dividend treatment for distributions of these earnings. Also the passive income test (as modified) is retained for corporations with accumulated earnings and profits to prevent the conversion of a regular corporation’s operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on accumulated corporate earnings as would occur if the corporation was liquidated. However, to reduce the likelihood of a termination of election, the bill, rather than terminating the election, would impose a corporate level tax in certain circumstances where the test is not met.\textsuperscript{15}

We assume the “bail out” is prevented by the ordering rules for the taxation of distributions from an S corporation having E&P. Once the accumulated adjustments account is reduced to zero, the next distributions are from E&P and fully taxable to the shareholders. Only after E&P is fully distributed will distributions be treated as a return of capital.

The 1982 legislative history does not further explain what purposes are being served by the both the termination provision for excess passive income, or the tax on excess net passive income. Further, the legislative history does not mention how the continuation of the termination provision and enactment of the tax on excess net passive income “encourages the use” of the Subchapter S rules, or eliminates or reduces the traps for those not knowledgeable of the intricacies of Subchapter S. Also, there is no mention of the reasons for the termination provision described in the Senate Report to the 1970 amendment.

The revised termination provision and the tax on excess net passive income were enacted prior to the repeal of the General Utilities doctrine in 1986, and may have made sense in a world without the section 1374 built-in gain tax. Today we do not believe that assets generating passive investment income should be treated any differently than assets producing business income when a C corporation converts to an S corporation.

This Option would simplify the administration of S corporations. For S corporations which have passive investment income, the cost of monitoring such income to avoid the termination rules can be quite high and burdensome. In some cases, S corporations with substantial passive investment income will find ways to increase their gross receipts from sources other than passive investment income, such as by purchasing a high gross receipts/low margin business, like a grocery store, to avoid the termination rule.

\textsuperscript{14} Id. at 6.
\textsuperscript{15} Id.
There is also uncertainty in the definition of some of the items constituting passive investment income, such as rents, where S corporations have sought expensive letter rulings from the Service.\textsuperscript{16}

The termination rule is also a trap for less sophisticated S corporations. Today there are more S corporations than C corporations, most of which are small businesses. Many S corporations are unaware of the termination rule or the tax on excess net passive income and fail to monitor their passive income. The results of a termination of S corporation status can be disastrous for the S corporation and its owner(s).

In many cases where this issue arises, it may be too late to take corrective action, such as a dividend or deemed dividend to eliminate all of the S corporation’s E&P. Although inadvertent termination relief may be available under section 1362(f), that can be a lengthy and costly process, with additional monitoring costs being necessary going forward after reinstatement of the S corporation election.

Also, simply eliminating an S corporation’s E&P by a dividend or deemed dividend can be risky if the C corporation, prior to conversion, did not carefully keep track of its E&P. An S corporation may err in its computation of E&P with the result that if it understates its E&P by even a small amount, say $10, the termination rule would continue to apply.

No similar restrictions apply to partnerships or limited liability companies taxed as partnerships.

Without a clear reason for this termination provision under current law, and in light of the limitation this provision places on small business corporations continuing under Subchapter S, the time may have come to repeal this provision. Therefore, to simplify the administration of Subchapter S and eliminate the traps for the less sophisticated small businesses, the Option to repeal section 1362(d)(3) is submitted for your consideration.

III. \hspace{1em} OPTION FOR CONSIDERATION.

We offer for your consideration the Option of repealing the S corporation termination rule of section 1362(d)(3). In the event that the section 1375 corporate-level tax on excess net passive income is not repealed (see next Option), then section 1362(d)(3)(B) through (C) will need to be added to the definitions in section 1375(b). Specifically, the present section 1375(b)(3) would be deleted. The present section 1375(b)(4) would be renumbered as section 1375(b)(3). The present section 1362(d)(3)(B) would be renumbered as section 1375(b)(4) and section 1362(d)(3)(C) would be renumbered as section 1375(b)(5).

Note that H.R. 1478 (the S Corporation Modernization Act of 2011), that was introduced on April 12, 2011, proposes the repeal of the section 1362(d)(3) termination rule. However, no action has been taken on this bill.

\textsuperscript{16} Note that the Service has recently announced that it will no longer issue private letter rulings on whether gross receipts from royalties, rents, dividends, interest, and annuities are passive income under section 1362(d)(3). Rev. Proc. 2011-3, 2011-1 I.R.B. 111.
OPTION 2: REPEAL THE TAX ON EXCESS NET PASSIVE INCOME

I. PRESENT LAW.


Under section 1375(a), an S corporation with accumulated earnings and profits that derives more than 25 percent of its gross receipts from passive investment income is subject to tax on its excess net passive income at the highest rate of tax specified in section 11(b). Subject to certain statutory exceptions, section 1362(d)(3)(D) defines passive investment income as “gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).”

The tax imposed by section 1375 has no application to an S corporation whose S corporation election has been in effect from its incorporation, or, if a C corporation converted to S corporation status, it has no earnings and profits from the taxable years it was a C corporation. Also, the tax does not apply if the S corporation distributes all such earnings and profits.17

Legislative History and Intent.

Congress added the tax to the Code as part of the Subchapter S Revision Act of 1982.18 The Senate Finance Committee Report stated that:

The passive income test (as modified) is retained for corporations with accumulated earnings and profits to prevent the conversion of a regular corporation’s operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on corporate accumulated earnings as would occur if the corporation was liquidated. However, to reduce the likelihood of a termination of election, the bill, rather than terminating the election, would impose a corporate level tax in certain circumstances where the test is not met.19

Tax Planning.

Taxpayers who are aware of the tax on excess passive investment income may plan their organizational and business operations to minimize or avoid the tax on excess passive investment income. These techniques include:

17 Alternatively, with the consent of all its shareholders, the corporation could make a deemed distribution of such E&P. See discussion under Option 1.
(i) Distributing (or making a deemed distribution of) earnings and profits.\(^{20}\)

(ii) Increasing gross receipts to minimize the percentage of passive income,\(^{21}\) and

(iii) Converting passive income to active income.\(^{22}\)

II. REASON FOR OPTION.

Throughout the history of S corporations, the purpose and ability of S corporations to own and manage passive investment-type assets has been a difficult issue with which to deal. Since its enactment, Subchapter S has provided that an S corporation election terminates if the S corporation has excess passive investment income.\(^{23}\) The tax on excess net passive income was added in 1982. The legislative history is vague. It is not clear what was meant by preventing “the conversion of a regular corporation’s operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on corporate accumulated earnings as would occur if the corporation was liquidated.”\(^{24}\) This statement seems to imply that the tax on excess net passive income is some substitute for taxing an S corporation election as a corporate liquidation, a treatment which was never intended and has never been part of Subchapter S. Any passive income earned by the S corporation flows through to and is taxable by its shareholders, so there is still one level of tax on that income.

Possibly the concern was that C corporations subject to (or at risk of becoming subject to) the personal holding company tax might convert to S corporation status to avoid the tax. However, this concern is not stated in the legislative history and is difficult to infer from what was stated.

The primary purpose for making an S corporation election is to avoid the corporate level tax, and the changes made by the Subchapter S Revision Act of 1982 were designed to encourage small business corporations to take advantage of Subchapter S and eliminate traps for the unwary. It is difficult to reconcile the tax on excess net passive income with these purposes.

The total amount of tax collected under this provision was $45.607 million in 2006 and $70.004 million in 2007, the last year for which statistics were published by the Service.\(^{25}\) Although it is possible that the tax on excess net passive income may accelerate distributions of E&P, with the current lower tax rate on qualified dividends, the total revenue effect may be nominal.

\(^{20}\) Such a distribution can be beneficial in 2011 and 2012 due to the lower tax rate applicable to dividends.


\(^{22}\) The Service has been generous in allowing taxpayers to reorganize their business operations to convert what is normally considered passive income to active by providing services in conjunction with the activity. See, e.g., Rev. Rul. 65-91, 1965-1 C.B. 43; Rev. Rul. 83-139, 1983-2 C.B. 150; PLR 200203017 (Jan. 18, 2002); and extensive discussion and detailed research and citations at Starr and Sobol, S Corporation Operations, 731 2nd Tax Mngt. Port. (BNA) at A-8 to A-17 (2011).

\(^{23}\) See discussion in Proposal 2.


The tax on excess net passive income is also a trap for the unwary. The tax can be avoided or minimized by careful tax planning, but one needs to be aware of the tax and timely plan for such avoidance.

Without a clear rationale for continuing the tax on excess net passive income, we believe that its repeal would simplify Subchapter S, eliminate traps for the unwary, reduce the administrative and recordkeeping requirements for S corporations, and promote use of Subchapter S and the economic growth of small business corporation.

III. OPTION FOR CONSIDERATION.

We offer for your consideration the Option to repeal section 1375.
OPTION 4: PERMIT S CORPORATION ELECTION TO BE MADE WITH THE FEDERAL TAX RETURN FOR THE FIRST YEAR FOR WHICH THE ELECTION IS TO BE EFFECTIVE

I. PRESENT LAW.

A small business corporation, as defined in the Code, may elect to be an S corporation. As previously noted in these Options, an S corporation generally pays no corporate level tax as the S corporation’s items of income and loss pass through and are taken into account on the S corporation shareholders’ individual tax returns. From its inception, the S corporation tax provisions have been intended to promote small businesses in this country.26

A small business corporation may file an S corporation election at any time during the taxable year preceding the year in which the election is to be effective or during the year in which the election is to be effective, provided that it is filed not later than the 15th day of the third month of that year.27 An election made after the 15th day of the third month is not effective until the succeeding year.28 The S corporation election is made by timely filing Form 2553 with the service center specified in the instructions accompanying that form.29

Historically, the Service lacked authority to approve an S corporation election that was not timely filed. Recognizing the inequity resulting from this lack of authority and the “trap for the unwary” it created, Congress, in the Small Business Job Protection Act of 1996,30 authorized the Service to treat a late S corporation election as timely filed if the small business corporation demonstrated reasonable cause. A small business corporation generally must request this relief through the private letter ruling process, including payment of the applicable user fee.31 The Service grants numerous private letter rulings with regard to late S corporation elections each year.

Current tax guidance amplifies this authority. Rev. Proc. 2003-4332 and Rev. Proc. 2007-6233 provide simplified procedures to request and obtain relief for a late S corporation election if the small business corporation and its shareholders satisfy the requirements set forth in those revenue procedures. Significantly, the relief provided under these revenue procedures eliminates the need for the small business corporation to request a private letter ruling and pay the associated user fee. While the Service does not publish information about relief granted under these revenue procedures, it is reasonable to assume that relief from late S corporation elections

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27 I.R.C. § 1362(b)(1).
28 I.R.C. § 1362(b)(2).
29 Reg. § 1.1362-6(a)(2).
32 2003-1 C.B. 998.
is granted to a significant number of small business corporations and their shareholders each year.

II. REASONS FOR CHANGE.

Permitting a small business corporation and its shareholders to elect to be an S corporation on the first tax return filed by the small business corporation advances several important policies underlying the Code: (i) simplification for taxpayers, (ii) simplification and reduction in administrative burdens for the Service, and (iii) increased efficiencies for both taxpayers and the Service. By doing so, the legislative proposal advances the paramount objective of Subchapter S, the promotion of American small businesses.

This Option provides simplification for small business corporations and their shareholders who desire to make the S corporation election. By permitting the S corporation election to be made on the first tax return of the small business corporation, this Option eliminates the requirement for taxpayers to prepare, or incur the cost to have prepared, and file the requisite election form. In addition, this Option eliminates a trap for the unwary as late S corporation elections are common errors made by taxpayers, and such errors are routinely discovered as the first tax return for the purported S corporation is being prepared. Finally, this Option eliminates the need for taxpayers to seek relief for inadvertent untimely S elections, either through the letter ruling process or under the revenue procedures described above.

This Option also provides simplification and reduces the administrative burdens imposed on the Service under the current S corporation election process. By permitting the S corporation election to be made on the first tax return of the small business corporation, this Option reduces the burden on the Service to receive and process S corporation elections made prior to filing of the returns. Further, this Option proposal reduces the audit burden on the Service to determine if S corporation elections were timely made. Finally, this Option relieves the burden on the Service to process, review and issue determinations on requests for relief from taxpayers that file untimely S elections.

III. OPTION FOR CONSIDERATION.

We offer for your consideration the Option of amending section 1362(b) to provide, in pertinent part, as follows:

(1) In General. -- An election under section (a) may be made by a small business corporation for any taxable year -- (A) at any time during the preceding taxable year, or (B) on a timely filed (including extension) federal tax return for the small business corporation for the taxable year for the year in which the election is to be effective.

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(3) Election Made After Return Filed. -- If (A) a small business corporation makes an election under subsection (a) for any taxable year, and (B) such election
is made after the date set forth in paragraph (1)(B) and on or before the date set forth in paragraph (1)(B) for the following taxable year, then such election shall be treated as made for the following taxable year.
OPTION 4: ALLOW BASIS INCREASE FOR BACK-TO-BACK LOANS REGARDLESS OF SOURCE OF FUNDS

I. PRESENT LAW.

Under section 1363(a), an S corporation generally is treated as a pass-through entity, and not a taxable entity, for federal income tax purposes. As such, the S corporation’s shareholders generally are subject to only one level of tax on the corporation’s earnings. Section 1366(a)(1) generally provides that all items of income, loss, deduction and credit of an S corporation pass through the corporation and are taken into account directly by its shareholders in proportion to their ownership interests in the corporation. In this respect, S corporations and their shareholders are treated similarly to partnerships and their partners.34

An S corporation shareholder may deduct the allocable portion of the S corporation’s losses under section 1366(a) only if the shareholder has sufficient basis in the S corporation’s stock and/or debt under the basis limitation rules of section 1366(d). This is an additional instance in which S corporations are similar to partnerships.35 Section 1366(d)(1) provides, however, that the total amount of losses and deductions taken into account by an S corporation shareholder for any taxable year may not exceed the sum of: (A) the adjusted basis of the shareholder’s stock in the S corporation, and (B) the shareholder’s adjusted basis in any indebtedness of the S corporation to the shareholder.

Under section 1366(d)(1), S corporation shareholders are treated differently than partners of partnerships. Under the partnership rules, “[a]ny increase in a partner’s share of the liabilities of a partnership . . . shall be considered as a contribution of money by such partner to the partnership,” which creates additional basis available to absorb losses for the partner.36 Thus, even a third-party loan to the partnership (whether or not guaranteed by the partners) may generate basis at the partner level, whereas for S corporations the loan must be made by the shareholder so that it becomes “indebtedness of the S corporation to the shareholder” for there to be a basis increase under the S corporation loss basis limitation rules.37

Section 1366(d)(1)(B) does not specifically define what constitutes “indebtedness of the S corporation to the shareholder.” The Senate Finance Committee Report accompanying prior section 1374(c)(2), the predecessor to current section 1366(d), indicates that the purpose of the provision was to limit the amount of an S corporation’s loss that may be deducted by a shareholder to the “adjusted basis of the shareholder’s investment in the corporation.”38

34 See I.R.C. § 702.
35 See I.R.C. § 704(d).
36 See I.R.C. §§ 752(a) and 722.
37 I.R.C. § 1366(d)(2) provides for a carryover of any losses or deductions passing through to an S corporation shareholder that are disallowed because of the basis limitation rules prescribed under section 1366(d)(1). The carryforward of losses under section 1366(d)(2) generally ceases when the shareholder’s interest in the S corporation terminates, the shareholder dies, or the corporation ceases to be an S corporation. Reg. § 1.1366-2(a)(5), -2(b).
Although section 1366(d)(1)(B) provides that a shareholder is entitled to deduct his or her proportionate share of the S corporation’s losses and deductions to the extent of such shareholder’s adjusted basis in debt owed to such shareholder by the S corporation, it does not specifically define what constitutes “indebtedness of the S corporation to the shareholder.” A number of cases and rulings interpreting section 1366(d)(1)(B) have established two requirements that generally must be met in order for a loan to constitute “indebtedness of the S corporation to the shareholder” within the meaning of section 1366(d)(1)(B):

1. the indebtedness must run directly from the S corporation to the shareholder; and
2. the shareholder must have made an “actual economic outlay.”

Cases and rulings interpreting section 1366(d)(1)(B) generally have held that indebtedness of the S corporation must be owed to the shareholder, and not to a related entity, for the indebtedness to increase the shareholder’s basis available to absorb losses from the S corporation. Thus, shareholders have been denied an increase in basis with respect to loans

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39 See the following authorities which deny a basis increase in situations originally involving related parties: TAM 9403003 (Sept. 29, 1993); Bergman v. United States, 74 F.3d 928 (8th Cir. 1999); Underwood v. Commissioner, 63 T.C. 468 (1975), aff’d, 535 F.2d 309 (5th Cir. 1976); Shebester v. Commissioner, 53 T.C.M (CCH) 824, T.C.M. (RIA) 87246; Griffith v. Commissioner, 56 T.C.M. (CCH) 1263, T.C.M. (RIA) 89070; Wilson v. Commissioner, 62 T.C.M. (CCH) 1122, T.C.M. (RIA) 91544; Hitchins v. Commissioner, 103 T.C. 711 (1994); Bhatta v. Commissioner, 72 T.C.M. (CCH) 696; Thomas v. Commissioner, 83 T.C.M. (CCH) 1576; Oren v. Commissioner, 357 F.3d 854 (8th Cir. 2004); Kaplan v. Commissioner, 90 T.C.M. (CCH) 296, T.C.M. (RIA) 54729; Ruckriegel v. Commissioner, 91 T.C.M. (CCH) 1035, T.C.M. (RIA) 56485; Kerzner v. Commissioner, 97 T.C.M. (CCH) 1375; and Russell v. Commissioner, 97 T.C.M. (CCH) 1122, aff’d 619 F.3d 908 (8th Cir. 2010). But see Rose v. Commissioner, 101 AFTR 2d 2008-1888, 2008-1 USTC ¶50,318 (11th Cir. 2008), where the Eleventh Circuit allowed a basis increase in connection with a loan restructuring between related entities. See the following authorities which permit a basis increase in situations originally involving unrelated parties: Rev. Rul. 75-144, 1975-1 C.B. 277; Gilday v. Commissioner, T.C.M. (CCH) 1982-242; PLRs. 8747013 (Aug. 20, 1987) and 981101-6, 981101-7, and 981101-8 (Dec. 3, 1997); and Miller v. Commissioner, 91 T.C.M. (CCH) 1267, T.C.M. (RIA) 56544.

40 Although the courts and the Service generally have required that indebtedness of the S corporation be a direct obligation to the shareholder and not to another entity in which the shareholder owns an interest for a shareholder to increase basis under section 1366(d)(1)(B), several recent decisions have applied the so-called “incorporated pocketbook” theory to find that indirect loans increased basis. See Culnen v. Commissioner, 79 T.C.M. (CCH) 1933, 2000 T.C.M. (RIA) ¶ 2000-139; Yates v. Commissioner, 82 T.C.M. (CCH) 805, 2001 T.C.M. (RIA) 2001-280. Under this theory, if the shareholder has habitually used the corporation to make personal expenditures on the shareholder’s behalf (i.e., as an “incorporated pocketbook”), the Tax Court has treated the related corporation as having made the loan on behalf of, or as agent for, the shareholder and specifically stated that the taxpayer has simply skipped the steps of having the corporation first lend the funds to the shareholder and then having the shareholder lend the funds to the S corporation. In essence, the cases have allowed basis increases for taxpayers who ignored corporate formalities and simply operated their related entities in a “sloppy” fashion, while denying basis to taxpayers who have properly structured and carefully documented their back-to-back loan restructurings. See, e.g., Bergman v. United States, 74 F.3d 928 (8th Cir. 1999); Kerzner v. Commissioner, 97 T.C.M. (CCH) 1375, 2006 T.C.M. (RIA) ¶ 2009-76. We believe that rewarding sloppy taxpayers and penalizing careful taxpayers is not good tax policy. Also see Miles Prod. Co. v. Commissioner, 28 T.C.M. (CCH) 1387, 1969 T.C.M. (RIA) ¶ 29876, aff’d on other issues, 457 F.2d 1150 (5th Cir. 1972) (shareholder allowed to increase his basis in an S corporation with respect to a loan made to the S corporation from a related corporation because the loan was treated as a constructive dividend to the shareholder followed by a capital contribution of the amount received as a dividend to his S corporation).
made to their S corporations by other corporations, partnerships, trusts and estates in which the shareholders held interests. In *Bader v. Commissioner*, the Service denied an S corporation shareholder a basis increase even though the loan had originally been made by a third-party bank to the shareholder, who in turn had loaned such funds to the S corporation, because the loan had subsequently been restructured so that it was a loan from the bank to the S corporation (rather than to the shareholder).

It is the second requirement that has proven most problematic for taxpayers and with respect to which the courts have rendered arguably inconsistent and confusing decisions. Specifically, the Service, and the courts in a number of cases, have found that in order for the S corporation shareholder to receive an increase in basis in connection with a back-to-back loan, the shareholder must have made an “actual economic outlay” in such a manner that the shareholder is “poorer in a material sense” after the transaction than before the transaction began. In general, these rulings and cases have tended to allow basis increases only if the funds loaned to the S corporation originally came from an unrelated party as opposed to another entity in which the shareholder has an interest.

Because of the confusion resulting from the case law and rulings that has left practitioners with little guidance on how to properly structure (or restructure) a back-to-back loan in such a manner that will provide the S corporation shareholder with basis in debt owed to such shareholder by the S corporation for purposes of section 1366(d)(1)(B), the Department of the Treasury published proposed regulations on June 12, 2012 on the types of back-to-back loan arrangements that will provide basis increases and the types of back-to-back loan arrangements that will not provide basis increases for the S corporation shareholder. In general, the proposed regulations follow the recommendations made by the American Bar Association Section of Taxation that so long as the loan transaction represents bona fide indebtedness of the S corporation to the shareholder, the shareholder should be allowed to increase his basis in the S corporation under section 1366(d)(1)(B). Significantly, the preamble (but not the actual regulations) provides that so long as the purported indebtedness of the S corporation to the shareholder is bona fide indebtedness to the shareholder, the S corporation shareholder need not otherwise satisfy the “actual economic outlay” doctrine for purposes of section 1366(d)(1)(B).

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41 *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100, 1984 T.C.M. (RIA) ¶ 40997 (shareholders not allowed to increase basis when their S corporation borrowed money from another S corporation in which the shareholders also owned an interest).

42 *Frankel v. Commissioner*, 61 T.C. 343 (1973), aff’d without published opinion, 506 F.2d 1051 (3rd Cir. 1974) (shareholders not allowed to increase basis when their S corporation borrowed money from a partnership in which the shareholders were partners); Rev. Rul. 69-125, 1969-1 C.B. 207 (same).

43 *Robertson v. United States*, 73-2 USTC (CCH) ¶ 9645 (D. Nev. 1973) (shareholders not allowed to increase basis when their S corporation borrowed money from a trust in which the shareholders were beneficiaries).

44 *Prashker v. Commissioner*, 59 T.C. 172 (1972) (shareholder not allowed to increase basis when S corporation borrowed money from an estate in which the shareholder was the sole beneficiary).

45 52 T.C.M. (CCH) 1398, 1987 T.C.M. (RIA) ¶ 43637.

46 See supra Note 48.

47 Id.


As pointed out in the ABA Tax Section’s comments, the application of the actual economic outlay test did not make sense in the back-to-back loan area, and was being applied without any statutory or economic justification.\textsuperscript{50}

The proposed regulations do not attempt to provide a standard for purposes of section 1366 as to what constitutes “bona fide indebtedness.” Rather, the preamble provides that general federal tax principles determine whether the indebtedness is bona fide. Although some commentators have been critical of the proposed regulations based on their lack of a definition of what constitutes bona fide indebtedness,\textsuperscript{51} the proposed regulations’ dismissal of the actual economic outlay test is a huge step forward for taxpayers.

The proposed regulations constitute a vast improvement over the current state of the law which has applied the “actual economic outlay” test and the “poorer in a material sense” concept to determine whether a shareholder is entitled to a basis increase under section 1366(d)(1)(B). The Service should be applauded for its efforts and its consideration of the input provided by the ABA Tax Section and the American Institute of Certified Public Accountants (AICPA). We are troubled, however, by the possibility left open by the proposed regulations that the Service might still attempt to apply the “economic outlay” requirement and the “poorer in a material sense” concept in determining stock basis under section 1366(d)(1)(A).

Because we believe that further clarification is needed with respect to this concern in the proposed regulations, and because the regulations, even if finalized with the clarifications discussed above, do not necessarily have to be followed by the courts in light of the substantial precedent requiring an “actual economic outlay” to increase a shareholder’s basis under section 1366(d)(1)(B), we believe the Option of amending section 1366(d)(1)(B) suggested below would be helpful for purposes of clarification and simplification.

II. REASONS FOR OPTION.

Permitting S corporation shareholders to increase their basis for loans made by them to S corporations (regardless of the source of the funds for the loan) would advance several important policies underlying the Code: (1) simplification for taxpayers and reduction in administrative burdens for the Service; (2) providing certainty for taxpayers and the Service in an area of law that is currently fraught with uncertainty; and (3) removing a trap for unsophisticated taxpayers and the unwary.

Comments on section 1366(d)(1)(B) were previously submitted by both the American Institute of Certified Public Accountants\textsuperscript{52} and by the ABA Section of Taxation.\textsuperscript{53} Those prior comments were consistent in that they pointed out that: (1) back-to-back loans are not inherently abusive transactions regardless of whether the funds are provided by an unrelated third party or a related party and should be respected if the original loan is enforceable against the shareholder;
(2) the application of the “economic outlay” and “poorer in a material sense” language in a number of cases does not provide a workable basis for determining whether debt constitutes “indebtedness of the S corporation to the shareholder” under section 1366(d)(1)(B); (3) there is no statutory basis for the application of the economic outlay test with respect to section 1366(d)(1)(B); and (4) there is no economic basis for application of the “poorer in a material sense” test in the back-to-back loan context.

Adoption of the Option described below would provide simplification for S corporations and their shareholders by permitting an S corporation shareholder to increase his or her basis in an S corporation for purposes of section 1366(d)(1)(B) for bona fide loans made by a shareholder to the S corporation, regardless of the source from which the shareholder obtained the funds that were thereafter loaned by him or her to the S corporation.

This Option would also eliminate the substantial uncertainty in determining what constitutes “indebtedness of the S corporation to the shareholder” under section 1366(d)(1)(B), which has not only resulted in substantial litigation between taxpayers and the Service, but also left taxpayers without any clear guidance in this area.

Today there are more entities taxed as S corporations than are taxed as partnerships or as C corporations, and it is projected to stay that way for the foreseeable future. Many S corporation owners are unaware that the Service and the courts sometimes treat funds obtained by a shareholder from a related entity and then loaned to an S corporation differently (i.e., no basis increase allowed) than funds obtained by the shareholder from an unrelated third party (such as a bank) and then loaned to an S corporation (i.e., basis increase allowed).

As pointed out above, we are unaware of any statutory or economic justification for treating funds obtained from a related party and then loaned to an S corporation differently from funds obtained from an unrelated party and then loaned to an S corporation. As such, this Option will provide fairness and equity to shareholders in S corporations, and ensure that the statute is applied as written and intended.

This Option will also reduce the administrative burdens imposed on the Service under current law. As pointed out above, significant litigation between the Service and taxpayers has occurred over the years in determining what qualifies as a back-to-back loan sufficient for an S corporation shareholder to increase his basis in the S corporation under section 1366(d)(1)(B), and the results have been inconsistent. The proposed regulations, even if finalized and clarified as suggested above, may not result in the certainty a legislative amendment to section 1366(d)(1)(B) will provide. This Option will significantly reduce the audit burden of the Service to determine whether indebtedness of an S corporation provides a basis increase for S corporation shareholders, and will also eliminate time consuming and costly litigation over this issue.

55 See supra Note 8.
III. **OPTION FOR CONSIDERATION.**

We offer for your consideration the Option of amending section 1366(d)(1)(B) to clarify that an S corporation shareholder be allowed to increase his or her basis in the S corporation for amounts loaned by the shareholder to the S corporation, regardless of the source of the funds loaned to the S corporation. Specifically, under the Option, section 1366(d)(1)(B) would be amended to read as follows:

“(B) the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year), regardless of whether the funds loaned by the shareholder to the S corporation are obtained by a loan from an unrelated third party, a loan or distribution from a related party or entity, or from the shareholder’s personal funds.”