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SUBCHAPTERS S AND R OF CHAPTER 1 OF THE INTERNAL REVENUE CODE OF 1954

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Mr. LONG of Louisiana, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 9883]

The Committee on Finance, to which was referred the bill (H.R. 9883) to amend subchapter S of chapter 1 of the Internal Revenue Code of 1954, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

Your committee has adopted the three House-passed provisions of H.R. 9883, relating to the option for corporations and their shareholders to be taxed in a manner similar to partnerships and partners, with only minor technical changes. It has, however, added an amendment relating to the option for unincorporated businesses to be taxed like corporations. This substantive amendment added by your committee repeals the provision of the code which provides a special option for partnerships and proprietorships to be taxed basically like corporations. It also provides for the tax-free incorporation of these businesses in certain cases.

In 1958 Congress enacted a series of provisions (secs. 1371–1377 of the code) designed to permit small business corporations and their shareholders to be taxed basically like partnerships and partners. Thus, corporations electing this status are not subject to tax but, instead, "pass through" to their shareholders the taxable consequences of their activities. This election was granted in order to minimize the effect of Federal income taxes on businessmen's choices of the form of organization which they conduct their business.

Since the enactment of these provisions in 1958, certain problems have arisen with the operation of this election. This bill deals with three such problems. It deals with two types of problems which resulted in unintended burdens and another which presents the possibility of tax manipulation which may lead to unintended benefits.

The first section of the bill provides that distributions of money made within 2½ months after the end of a year are to be considered as distributions of the undistributed taxable income of the corporation, which was taxed to the shareholders on the last day of the corporation's taxable year. As a result, these distributions made in this first 2½-month period will not again be taxed as dividends to the shareholders (as they are under present law where they are treated as distributions out of the earnings and profits of the corporation for the year in which distributed to the extent of those earnings and profits). The change described above applies with respect to distributions made after the date of enactment of this bill. However, for periods back to the adoption of this "passthrough" provision in 1958 this new rule will apply to open years, but on an elective basis and with respect to distributions made in the first 3½ months after the end of the year in question. It is also to apply on an elective basis to refunds for certain "closed" years where there is a close correlation between the distributions made in such a 3½-month period and the undistributed earnings of the corporation at the end of the prior year.

The second section of the bill amends the "passthrough" election to prevent its use as a device to avoid a capital gains tax. Thus, except where a small business corporation has elected the "passthrough" treatment for the 3 prior years (or from the time of its existence, if shorter), under certain conditions capital gains are to be taxed to the corporation as well as to the shareholders. Capital gains in such cases will be taxed to the corporation (as well as the shareholder) if they are greater than the corporation's ordinary income, but only to the extent they exceed $25,000 (also, only if the corporation's taxable income exceeds $25,000). This provision applies to taxable years of these corporations beginning after the date of enactment of this bill.

The third section of the bill is designed to eliminate the hardship of an unexpected termination of the "passthrough" election where a corporation in its initial period of operation derives more than 20 percent of its income from passive investment sources. This may well occur as a result of it not commencing business operations as soon as anticipated. The bill suspends this 20-percent requirement in the first 2 years of a corporation's active conduct of business where the passive investment income for any year involved is less than $3,000. This provision applies to taxable years of corporations ending after the date of enactment of this bill. It also applies on an elective basis with respect to taxable years beginning after December 31, 1962.

The fourth section of the bill, added by your committee, repeals the provision of the code (sec. 1361) which presently permits proprietorships and certain partnerships to elect to be taxed basically like corporations. This provision, which is substantially the reverse of the "passthrough" treatment described above, preceded the "passthrough" treatment in adoption, having been enacted in 1954. The repeal of this provision will become effective January 1, 1969. In the meanwhile, a partnership or proprietorship which had previously made this election is permitted to become an actual corporation in a tax-free reorganization. After the date of enactment of this bill, no partnership or proprietorship which is not already under the election will be permitted to elect the corporate tax treatment.

The Treasury Department has indicated that it has no objection to the House-passed provisions and favors the adoption of the amendments made by your committee.

II. GENERAL EXPLANATION

A. DISTRIBUTIONS AFTER THE END OF THE YEAR (SEC. 1 OF THE BILL)

While the tax treatment accorded the small business corporations and their shareholders is similar to the Federal income tax treatment accorded partnerships and their partners, certain differences continue as a result of the corporate form of these organizations. For example, one of these small business corporations may have previously been taxed as a regular corporation with the result that when these earnings and profits previously earned are treated as distributed, they represent an ordinary dividend from a corporation.

The present small business corporation provision treats distributions of money made during the corporation's year as being made first out of the corporation's earnings and profits of that year. If the corporation's income for the year exceeds these actual distributions made during the year, then this remaining income is treated as if it were distributed to the shareholders on the last day of the corporation's year and taxed to the shareholders as if received by them at that time. On the other hand, if the small business corporation actually distributes more money than its income for the year, this excess amount would generally be considered as the income of the prior year or years. If the corporation had elected this "passthrough" option in the prior year, this excess amount would not be taxable to the shareholders but only if this amount had already been taken into the shareholders' income in a year prior to that in which they received the distribution.

While in most respects the rules described above as to the order of distributions have worked well, nevertheless, they have presented problems where distributions have been made shortly after the end of a year. As a practical matter, corporate officers frequently do not know the amount of the corporation's income until after its year has ended. Consequently, it is difficult to distribute the entire amount of the corporation's income within the year. (This problem has been met elsewhere in the internal revenue laws by allowing amounts distributed for a limited period after the end of a year to be treated as a distribution made during a year.) In addition, taxpayers who think of small business corporations as being taxed like partnerships fail to recognize the significance of the timing of a distribution by the corporation. In the case of a partnership, the income of the partnership is taxed to the partners, whether or not distributed, and the timing of the distribution of the partnership earnings as such makes little or no difference for tax purposes.

The effect of postponing a distribution until after the end of the year in the case of a small business corporation in some cases has little tax consequences, while in other cases it can work substantial hardships on the shareholders.

One type of situation where hardship may exist in the case of such a distribution made shortly after the end of a year arises where the shareholder is on a taxable year ending 1 month or more after that of the corporation. This can be illustrated by a corporation with the taxable year ending on November 30 and a shareholder with a taxable year ending on December 31. In such a case, if the corporation has made no distribution by November 30, each shareholder is taxed on his proportionate share of the taxable income of the corporation for that year. If the corporation then distributes this income to the shareholders during December, the shareholder will be faced with a double inclusion of the corporation's earnings in 1 year since such a shareholder first is taxed on his share of the undistributed earnings as of November 30; then, when the actual distribution is made in the following December, it is treated as a distribution out of the earnings and profits of the corporation for that following year. Thus, this distribution, too, is taxable to the shareholder.

It is, of course, true that in the shareholder's next year he will not be taxed on the corporate earnings for that year (assuming the profits for the year do not exceed the distribution). However, because of the progressive structure of the individual income tax rates, such a shareholder may suffer a substantial detriment by having two inclusions made in 1 year with respect to what was intended to be the same corporate earnings even though he is not taxed on these corporate earnings in the following year.

Another problem has arisen because a distribution is treated as being paid out of the prior year's undistributed taxable income only when this income already has been taxed to the shareholders at the time of the actual distribution. The problem arises when the year of a shareholder, to which the undistributed taxable income is attributed for tax purposes, extends beyond that of the corporation and has not closed prior to the time of the actual distribution. (See regulations, secs. 1.1375–4(d) and 1.1375–4(g), example No. 2.) In such cases if there is no undistributed taxable income in prior years, the distribution may be treated as being paid out of earnings and profits of the corporation for years before it elected the "passthrough" treatment and therefore be treated as an ordinary dividend to the shareholder.

Problems have also arisen, whether or not the corporation and shareholders are on different years, where for one reason or another the "passthrough" election is terminated in the year in which the actual distribution is made. The problems become particularly severe where the corporation does not intend to distribute its profits of this second year. In such a case, despite this intent, the actual distribution made (which the corporation intended to be out of the earnings of the prior year) nevertheless, is treated as a dividend in the actual year of distribution. As a result, the shareholder is taxed on these amounts at this time and also is taxed on the earnings of the prior year which were undistributed at the end of that year. A number of problems of this type have occurred since 1958 in the operation of these provisions, working unintended hardships on shareholders.

Section 1 of this bill deals with this problem for the future and also provides a mechanism for the relief of those taxpayers who were misled in their understanding of the "passthrough" election in the past.

The bill provides, in the case of an electing small business corporation, that distributions of money to shareholders within 2½ months after the close of a taxable year are to be treated as distributions of the corporation's undistributed taxable income for the year just ended, to the extent that these distributions do not exceed this undistributed taxable income. This treatment is similar to that provided in the case of the accumulated earnings tax and in the case of personal holding companies. This rule is expected to afford corporations a reasonable time after the end of a year to determine how much their profit was and to distribute it to their shareholders. Yet, the period within which these distributions must be made is sufficiently short so that the shareholders can, in effect, elect to treat distributions (by waiting 2½ months) as having been made out of the current year's income without unduly delaying the distribution in order to achieve that result.

Present law (sec. 1375(e)) already permits distributions of the proceeds of a sale of capital assets to be treated as having been made on the last day of the taxable year within which the sale occurred, if the distributions are made within 2½ months after the end of that taxable year and were made pursuant to a resolution of the board of directors adopted before the end of the year in question. This treatment is available only if each shareholder owns the same proportion of the corporation's stock on the distribution date as he did on the last days of the corporation's last taxable year.

In view of the significant overlap between this existing subsection and the new subsection added by this bill, your committee agrees with the House that the retention of the existing subsection (sec. 1375(e)) is unnecessary and therefore this bill repeals this subsection. However, because corporations already may have entered into transactions intending to use this subsection, the repeal is to affect only distributions made after the close of taxable years beginning after the date of enactment of this bill. Thereafter, corporations should be able to qualify such transactions to a substantial degree under the new provision.

As has been indicated, it appears that numerous persons have misunderstood the distribution rules under existing law, assuming that the profits of an electing small business corporation could be distributed after the end of the year without tax effect in the same way as the profits of a partnership. Because of this apparently widely held misunderstanding, the bill applies the new provision described above, on an elective basis, to distributions made under similar circumstances before the enactment of this bill. Because any such application of this provision might affect adversely the tax liabilities of some shareholders, and (depending upon the circumstances of the individual case) might affect the corporation's accumulated earnings and profits, the bill requires this election to be consented to by all persons who were shareholders at any time on or after the date of the first applicable distribution, unless the Treasury Department determines that the nonconsenting shareholder's potential, and actual, tax liabilities could not be affected by the election.

Your committee also agrees with the House that it was appropriate in these cases to allow up to the ordinary time for filing individual income tax returns after the end of the year in these cases—namely, 3½, rather than 2½, months after the end of the year for these past distributions—since some such distributions apparently were not made until needed to make income tax payments for shareholders.

Elections regarding these past distributions must be made within 1 year after final regulations are published in the Federal Register.

Interest on deficiencies or overpayments resulting from elections regarding past distributions is not to be required or allowed for any period prior to 2 years after the publication of final regulations.

The bill provides that an election regarding past distributions may normally be made only as to a year that is still open. However, a credit or refund may be made for a closed year where the qualifying distributions (or the first few qualifying distributions) substantially equaled the undistributed taxable income of the corporation for its prior year. In addition a closed year may be opened for refunds if the taxpayer can show to the satisfaction of the Secretary of the Treasury or his delegate that the distributions were intended to be made out of the undistributed taxable income. Pertinent information might, for example, include a showing that the shareholders treated the distributions on their personal income tax returns as having been made out of the electing small business corporation's prior year's undistributed taxable income, a showing that the distributions approximated the shareholders' taxes on the prior year's income from the corporation, or a showing that on the corporation's tax return (as a part of the information required on the return by sec. 6037 of the code) it had treated such distributions as being made out of the prior year's undistributed taxable income.

Although it is expected that an election will not be made to apply the new provision to past distributions unless a refund will be available for the year designated in the election, other changes caused by the election might result in deficiencies for some stockholders for some of the intervening years which also may have been "closed." In order to avoid manipulation of open overpayment years against closed deficiency years, the bill provides that the statute of limitations for deficiencies for any years involved is not to expire for 1 year after the last date for filing an election under this provision.[1]

If the deficiency year would otherwise have been closed, then the deficiency may not exceed the amount attributable to an election under this provision.

If a claim for refund would not have been barred on the date of enactment of this bill but the statute of limitations would normally expire before 2 years after the final regulations on this point are published, then the years would remain open for the refund until the end of the 2 years. In this situation the refund may not exceed the overpayment attributable to an election under the proposed new provision.

B. AVOIDANCE OF CAPITAL GAINS TAX AT CORPORATE LEVEL (SEC. 2 OF THE BILL)

It has come to your committee's attention that the "passthrough" election has on occasion been used by corporations as a device for the avoidance of capital gains tax: A corporation in such a case arranges to have a large amount of capital gains realized in 1 year, elects the "passthrough" treatment for that year, distributes these realized capital gains, and then deliberately causes its "passthrough" status to be terminated. This avoids a capital gains tax at the corporate level and substitutes capital gains tax for an ordinary (dividend) income tax at the shareholder level. Normally, this could be done

[1] A deficiency assessment is not to be barred by the statute of limitations under these circumstances even if the statute has already run by the time the election is made and even if an assessment would normally be barred on account of a court decision as to the taxpayers' income tax liability for that year or because a binding closing agreement had been entered into for that year between the taxpayer and the Internal Revenue Service. Of course, the usual limitations in sec. 6213(a) on the Government's right to assess a deficiency will continue to apply and the running of the extended period of limitation will be suspended where sec. 6503 applies.

where a corporation sold its assets and completely liquidated within a 12-month period (under the provisions of sec. 337). However, by using the "passthrough" treatment the shareholders can obtain the same results without liquidating the business.

Such use of the "passthrough" treatment is contrary to the intent of Congress when it enacted this provision. It was basically intended for an operating business which for business reasons desired the corporate structure yet preferred tax treatment similar to that accorded a partnership. It was intended for an organization desiring this tax treatment at least for a number of years and certainly not for a single year as a device to avoid capital gains tax to the corporation.

This bill provides for the problem described above by adding a new provision (sec. 1378) to the tax laws imposing a tax upon the capital gains of a corporation which has elected the "passthrough" treatment under certain limited conditions. This tax is imposed only when the electing corporation has an excess of net long-term capital gain over any net short-term capital loss which exceeds its other taxable income and also exceeds $25,000.[2] In addition, where the corporation would have a loss for the year but for the excess of capital gain referred to above, the tax will apply only if the taxable income (taking into account this capital gain) is over $25,000.

Since this provision is intended to apply only in those situations where the "passthrough" treatment was elected to avoid taxes on capital gains, the tax is not to be applied in the case of corporations which have been under a "passthrough" election for at least the 3 immediately prior years. Alternatively the tax will not apply in the case of new corporations which have been in existence for less than the 3 prior years but have made the "passthrough" election for the entire period of their existence.

Where the conditions set forth above exist, a tax is to be imposed upon the electing corporation, equal to 25 percent of the excess of the net long-term capital gain over net short-term capital loss, but only to the extent this exceeds $25,000. However, the tax in no event is to exceed the tax which would have been imposed if the corporation had not elected the "passthrough."[3]

The tax imposed on an electing corporation by this provision will reduce the undistributed taxable income of the corporation and will therefore reduce the amount of income taxable to the shareholders by a like amount. As a result, the shareholders will not be required to pay a tax upon an amount which the corporation in fact paid out as its own tax. The income taxable to the shareholders, however, retains its character as capital gain.

The new provision (in sec. 1378(b)) which sets forth the tax rates, provides that credits generally are not to be allowed against the new capital gains tax imposed at the corporate level. This rule as to credits is designed to insure that the new provision will not extend to these "passthrough" corporations credits for which they would not be eligible in the absence of the special capital gains tax. This is consistent with the rule under present law, that if a corporation which has elected "passthrough" treatment would otherwise be entitled to an investment credit carryback or carryover from a year when the corporation was not subject to this "passthrough" treatment, then

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[2] Taxable income for this purpose is computed in the same manner as for corporations generally except that no deduction is allowed for a net operating loss carryover, for dividends received or for other deductions specified in secs. 241 to 247 of the code, inclusive.

[3] For this purpose the tax is computed on taxable income as defined in footnote No. 2.

neither the corporation nor the stockholders are permitted to receive this credit in a year when the corporation is subject to such treatment. The amount of the carryback or carryover available to be used in the next year would not be changed under present law. However, since a carryback or carryforward generally is reduced by a portion of the corporation's tax liability, and since the new provision added here would impose such a liability upon a "passthrough" corporation for the first time, it may be that the investment credit carryback or carryover would be reduced (in the absence of a provision to the contrary) by a portion of the special capital gains tax even though neither the corporation nor the shareholders are permitted to use the credit. To avoid this result, your committee has added a technical amendment to provide that this tax is not to be treated as a tax for purposes of determining the amount by which the investment credit carryover or carryback is reduced.

The requirement previously described, to the effect that a corporation will be subject to this special 25-percent capital gains tax unless it has elected the "passthrough" treatment for the 3 prior years, could be avoided (were no limitation to be imposed) by having an existing corporation participate in a reorganization and having a new corporation which comes out of the reorganization elect the "passthrough" treatment immediately upon its creation, or by transferring property in a tax-free transaction to a corporation which previously has made this election. In order to prevent these results, the bill provides that the tax is to apply to gains and losses from the disposition of property by an electing corporation if (1) the property was acquired in the year in question or within the 3 prior years; (2) the property was acquired from a corporation which was not itself an electing corporation during any of this period up to the time of the acquisition; and (3) the property has a substituted basis in the hands of the electing corporation. Thus, the special 25-percent tax will apply in those cases where the property in question was acquired in a taxfree transaction (such as the various types of corporate reorganizations) and the corporation from which the property was acquired had not used the "passthrough" election during any of this period up to the time of the acquisition. Where that corporation had itself acquired the property in a tax-free transaction, then this test would apply to the corporation from which that corporation had acquired the property.

This provision would apply to corporate taxable years beginning after the date of enactment of the bill.

C. PASSIVE INVESTMENT TEST IN THE CASE OF NEW BUSINESSES (SEC. 3 OF THE BILL)

When the "passthrough" type of tax treatment was provided for corporations, Congress decided to limit the availability of this treatment to small businesses actively engaged in trades or businesses. Therefore, it denied this treatment to corporations with large amounts of passive income. Accordingly, present law (sec. 1372(e)(5)) provides that a "passthrough" election is to terminate automatically where more than 20 percent of a corporation's gross receipts are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. To prevent a corporation from electing in and out of the "passthrough" status, present law (sec. 1372(f)) also provides that generally where a corporation terminates its "passthrough" election, it may not again elect this status until after the lapse of a 5-year period.

Attention has been called to a type of instance, which may well occur with some frequency, where the provisions described above work unintended hardships. New corporations, electing the "passthrough" treatment and intending to commence the operation of businesses, frequently have to improve real property and acquire tangible personal property before they can actually begin operations. Because of construction delays, or delays in obtaining the tangible personal property, the corporations may not produce the anticipated operating receipts in their first or second year of operation. Meanwhile, funds accumulated to pay the costs of construction (or the purchase price for the tangible personal assets) normally remain in interest-bearing accounts awaiting the subsequently required payments. The interest thus produced may well amount to more than 20 percent of a corporation's gross receipts particularly since its operating income may not yet have really begun to come in. Where this happens a corporation's "passthrough" status may automatically terminate. This status then cannot generally be renewed for 5 years.[4]

To meet this type of problem, the bill provides that a corporation is not to lose its "passthrough" status merely because its passive investment income exceeds 20 percent of its gross receipts during the first 2 taxable years in which it carried on the active conduct of a trade or business if its passive investment income for the year in question is less than $3,000.

This provision is to apply to corporate taxable years ending after the date of the bill's enactment. It is also to apply to earlier years beginning after December 31, 1962, at the election of the corporation if all persons who were shareholders at any time during those years consent to the application of this provision.

D. REPEAL OF PROVISIONS PERMITTING UNINCORPORATED BUSINESSES TO BE TAXED AS CORPORATIONS; TAX-FREE INCORPORATIONS OF SUCH BUSINESSES (SEC. 4 OF THE BILL)

1. *Repeal of provision*

In 1954 the Congress enacted a provision (sec. 1361) to permit proprietorships and partnerships to elect to be taxed basically like corporations.

The latest available Internal Revenue Service statistics indicate that there are probably fewer than 1,000 business entities which have elected this corporate tax option. Your committee has concluded that a provision of this complexity which has proved to be of such limited usefulness should not be continued.

Accordingly your committee's amendment repeals this provision. However, to permit businesses subject to this provision to plan their affairs in light of this repeal, your committee's amendment makes this repeal effective January 1, 1969. In the meanwhile, no new elections under this provision are to be permitted, but (as further explained below) entities presently subject to this provision will be

[4] Under present law (sec. 1372 (f)) a new election may be made in the 5-year period if the Commissioner of Internal Revenue gives his consent. However, in cases of this type the shareholders may not be aware of the fact that their election has been terminated until a revenue agent audits the corporation's return, some years later. Since a new election can have almost no retroactive effect (sec. 1372 (e)(1) and (d)), the shareholders in such cases usually cannot undo much of the effects of the termination.

permitted to incorporate in a tax-free reorganization. They may also liquidate in this period without incorporation.

Under present law (sec. 1361(f)) where there is a change of 20 percent or more in profits or capital interests of a business which has made this election, a new election must be made. Under your committee's amendment, such an election to continue the corporate tax treatment will be permitted until December 31, 1968, despite the general prohibition referred to above with respect to new elections.

2. Tax-free reorganizations

One of the major problems with this election for corporate tax treatment has been that where this election has been made and then subsequently the owners want to actually incorporate the business, this cannot be done in many cases without payment of substantial taxes. This occurs because it has been held that the incorporation of such a business must be treated first as a taxable liquidation of the business subject to the election and only then as the incorporation of the business. Two Tax Court decisions have agreed with the regulations (Regulations, sec. 1.1361-5(b)) in this respect.[5] This has proved to be a trap for the unwary and may well account for a substantial proportion of the less than 1,000 businesses under this option. They may not have been aware of this treatment initially and now cannot change their status without payment of heavy taxes. Action on situations of this type becomes especially important because repeal of this option would otherwise result in taxable liquidations, for Federal income tax purposes, of all of these businesses.

In view of the considerations set forth above your committee's amendment repeals the portions of this option resulting in this "liquidation-incorporation" concept in the regulations effective with the enactment of this act. Thus an incorporation of the business is to be treated under the provisions of present law relating to corporate organizations, reorganizations, etc. (pts. III and IV of subch. C of ch. 1 of the code). This in such cases generally will result in the tax-free incorporation of one of these businesses. However, to the extent that money or other property is withdrawn from the business and does not go over to the corporation, tax will apply in the same way as in the case of "boot" in any other corporate reorganization which otherwise is tax-free.

3. Revocation of elections

In view of your committee's amendment repealing this provision effective January 1, 1969, your committee sees no reason why an unincorporated business which has made an election to be taxed like a corporation should be required to remain in that status until that date, whether or not the owners of the business desire to form an actual corporation to continue the business. Accordingly, your committee has included an amendment to permit an election to be revoked on or before December 31, 1968. If an election is not revoked on or before this date, it will terminate on January 1, 1969. The revocation or termination of an election (without any transfer to an actual corporation) under your committee's amendment will be treated, for Federal income tax purposes, as a complete liquidation of a corporation.

[5] One decision was affirmed per curiam by the Court of Appeals for the Third Circuit and the other has been on appeal to the Court of Appeals for the Fifth Circuit for 17 months.

III. TECHNICAL EXPLANATION

SECTION 1. DISTRIBUTIONS OF SUBCHAPTER S CORPORATIONS AFTER CLOSE OF TAXABLE YEAR

(*a*) *Distributions within 2½-month period after close of taxable year.*—Under existing law, distributions of money by an electing small business corporation to its shareholders (other than distributions with respect to which an election is made under sec. 1375(e) of the code) are dividends out of earnings and profits of the taxable year in which the distributions are made to the extent of such earnings and profits. Further, under section 1375(d), such distributions in excess of earnings and profits of the year of distribution may be nondividend distributions of previously taxed income to a shareholder of such corporation only to the extent of amounts which have been included in his gross income under section 1373(b) for his taxable years ending before such distributions. Also, under existing law if an election under section 1372(a) is terminated under section 1372(e), the corporation may not, during the first taxable year to which the termination applies or during any subsequent taxable year, make nondividend distributions of previously taxed income of taxable years prior to the termination.

Distributions of undistributed taxable income

Subsection (a)(1) of the first section of the bill amends subchapter S of chapter 1 of the code by adding a subsection (f) to section 1375. Paragraph (1) of new section 1375(f) provides that any distribution of money made by a corporation which was an electing small business corporation for the taxable year immediately preceding the year of distribution (including a corporation with respect to which an election was terminated under sec. 1372(e) for the year in which the distribution is made) shall be treated as a distribution of the corporation's undistributed taxable income for such immediately preceding year—

(1) if it is made after the close of such immediately preceding year and on or before the 15th day of the 3d month following the close of such year;

(2) if it is made to a person who was a shareholder of such corporation at the close of such year; but

(3) only to the extent that such distribution (when added to the sum of all prior distributions of money made to such person by such corporation following the close of such year) does not exceed such person's share of the corporation's undistributed taxable income for such year.

Any distribution so treated shall, for purposes of chapter 1 of the code, be considered a distribtuion which is not a dividend, and the earnings and profits of the corporation are not to be reduced by reason of such distribution.

Share of undistributed taxable income

Paragraph (2) of new section 1375(f) provides that, for purposes of paragraph (1), a person's share of a corporation's undistributed taxable income for a taxable year is the amount required to be included in his gross income under section 1373(b) as a shareholder of such corporation for his taxable year in which or with which the taxable year of the corporation ends.

Thus, the treatment of distributions provided in new section 1375(f) is applicable only to distributions of money made to persons who were shareholders of the corporation on the last day of the corporation's taxable year immediately preceding the corporation's taxable year in which the distributions are made. Such treatment is applicable to the amount each such shareholder receives only to the extent of the amount required to be included in his gross income under section 1373(b) as a shareholder of the corporation on the last day of such immediately preceding year.

Election under section 1375(e)

Paragraph (3) of new section 1375(f) provides that paragraph (1) shall not apply to any distribution with respect to which an election under section 1375(e) applies. Thus, if a corporation makes an election under section 1375(e) with respect to a distribution of money, the treatment provided by new section 1375(f) does not apply to such distribution.

Repeal of section 1375(e).—Subsection (a)(2) of the first section of the bill repeals section 1375(e) of the code effective with respect to distributions made after the close of any taxable year beginning after the date of enactment of the bill. Thus, an election under section 1375(e) may be made only with respect to proceeds of sales which are made by an electing small business corporation before the close of its first taxable year ending after the date of enactment of the bill.

(*b*) *Technical amendment*.—Subsection (b) of the first section of the bill amends section 1375(d)(2)(B)(ii) of the code to provide that a shareholder's net share of undistributed taxable income for purposes of section 1375(d) (relating to distributions of undistributed taxable income previously taxed to shareholders) is reduced by distributions treated under new section 1375(f) as nondividend distributions.

The provisions of new section 1375(f) of the code are illustrated by the following examples:

Example (1).—X corporation, an electing small business corporation which uses the fiscal year ending March 31 as its taxable year, has two shareholders, A and B, calendar year taxpayers each owning 50 percent of its outstanding stock. For its year ending March 31, 1967, X has made no distributions to its shareholders and has undistributed taxable income (as defined in sec. 1373(c)) of $50,000. On May 1, 1967, X distributes $25,000 in money to A and $25,000 in money to B. X makes no further distributions to A and B during the calendar year 1967, even though it has earnings and profits of $60,000 for its taxable year ending on March 31, 1968.

Under existing law, A and B would each include $50,000 in gross income for the calendar year 1967; $25,000 of this would be includible under section 1373(b) and the other $25,000 would be includible by reason of the May 1, 1967, distribution. Pursuant to new section 1375(f), however, the May 1, 1967 distribution is treated as a distribution of X's undistributed taxable income for its year ending March 31, 1967, and will not increase A's and B's gross incomes.

Example (2).—Y corporation, an electing small business corporation which uses the calendar year as its taxable year, has two shareholders, C and D, calendar year taxpayers each owning 50 percent of its outstanding stock. For its taxable year 1966, Y has $20,000 of undistributed taxable income (as defined in sec. 1373(c)). At the beginning of 1967, C and D each have $25,000 as their respective net shares of previously taxed income, including the $10,000 which was required to be included in the gross income of C and D for 1966 as their respective shares of Y's undistributed taxable income for 1966. On February 1, 1967, Y distributes $15,000 in money to C and $15,000 in money to D. Y makes no other distributions during 1967 and has $40,000 of taxable income for such year. Of the $15,000 distributions made to C and D on February 1, 1967, $10,000 of each such distribution is treated as a distribution of Y's undistributed taxable income for 1966, pursuant to new section 1375(f), and is not a dividend to each shareholder. Pursuant to section 1375(d)(2)(B)(ii) of the code, as amended by subsection (b) of the first section of the bill, however, C's and D's net shares of previously taxed income are reduced by the amounts so treated to $15,000 each. The balance of each $15,000 distribution, $5,000, is a dividend to C and D out of Y's earnings and profits for 1967. At the end of 1967, Y has $30,000 of undistributed taxable income, allocated one-half to C and one-half to D as their respective shares to be included in their gross incomes for 1967.

Example (3).—Z corporation, which uses the calendar year as its taxable year, has two shareholders, E and F, calendar year taxpayers each owning 50 percent of its outstanding stock. Z has $10,000 of undistributed taxable income for 1966, a year for which it was an electing small business corporation. On February 15, 1967, F sells all of his stock in Z to G, who does not consent to the election of Z to be an electing small business corporation. Thus, the election is terminated effective for 1967 and all succeeding taxable years of Z. On March 1, 1967, Z distributes $5,000 in money to E and $5,000 in money to G. Under new section 1375(f), the distribution to E is treated as a distribution of Z's undistributed taxable income for 1966 because E was a shareholder of Z on the last day of 1966 and his share of such undistributed taxable income was $5,000. However, the distribution to G, who was not a shareholder of Z on the last day of 1966, is a distribution under section 301 of the code, and thus a dividend to the extent provided in section 316 of the code.

(c) *Effective date.*—Subsection (c) of the first section of the bill provides that the amendments made by subsections (a)(1) and (b) shall apply only with respect to distributions made after the date of enactment of the bill, except as provided in subsection (d) of the first section of the bill which is discussed below.

(d) *Distributions made before date of enactment.*—Subsection (d) of the first section of the bill provides rules for the application of new section 1375(f) (and the amendment of sec. 1375(d)(2)(B)(ii)) of the code to distributions of money made on or before the date of enactment of the bill. However, new section 1375(f) is not to apply to any such distribution with respect to which an election under section 1375(e) of the code applies.

Election and consents

Subsection (d)(1) of the first section of the bill provides that new section 1375(f) will apply to distributions of money made during any taxable year designated by a corporation, if it elects to have new section 1375(f) apply to all such distributions during such year and to all such distributions during subsequent years. Thus, when a corporation makes an election to have new section 1375(f) apply to distributions of money made on or before the date of enactment of the bill, it must designate a taxable year. New section 1375(f) will then apply to all such distributions made during the prescribed periods following the close of the taxable year immediately preceding the year designated, and each subsequent taxable year. For example, if a corporation designates the taxable year 1959, and it makes an effective election, new section 1375(f) will apply to all distributions of money made by the corporation during the prescribed periods following the taxable year 1958 and all subsequent years of the corporation.

In order for such an election by a corporation to be effective, except as otherwise provided by subsection (d) of the first section of the bill, all persons (or their personal representatives) who were shareholders of the corporation at any time on or after the date of the first distribution with respect to which the election applies, and before the date on which the corporation files the election with the Secretary of the Treasury or his delegate, must consent to such election and to the application of the provisions of subsection (d) of the first section of the bill. The persons who must consent under these provisions include persons who are not shareholders of the corporation at the time of the election but who were shareholders at any time during the period described above. For example, if the taxable year 1959 is the year designated by a calendar year corporation in its election filed on February 15, 1967, and the corporation made its first distribution in 1959 on January 15, 1959, all persons who were shareholders of the corporation at any time on or after January 15, 1959, and before February 15, 1967, including those who were no longer shareholders on February 15, 1967, must consent in order to have an effective election.

Subsection (d)(2) of the first section of the bill provides that an election by a corporation under such subsection, and the consent thereto by persons who are or were shareholders of such corporation, shall be made in such manner and within such time as the Secretary of the Treasury or his delegate prescribes by regulations. However, the period for making such election is not to expire before 1 year after the date on which the regulations prescribed under subsection (d) are published in the Federal Register.

Consents not required

Subsection (d)(3) provides that the consent of a person to an election by a corporation under subsection (d) (1) and (2) of section 1 of the bill shall not be required if, under regulations prescribed under subsection (d), it is shown to the satisfaction of the Secretary of the Treasury or his delegate that the liability for Federal income tax of such person cannot be affected by the election of the corporation of which he is or was a shareholder. It is possible that a person's liability for Federal income tax may be affected even though he was not a shareholder on the date of the distribution with respect to which new section 1375(f) applies. For example, a reduction in the corporation's earnings and profits made under existing law may be restored under the last sentence of section 1375(f)(1). This restoration could affect the amount of subsequent distributions to a shareholder which are considered dividends out of earnings and profits. In any such case, the consent of such shareholder would therefore be required.

Three and one-half month period

Subsection (d)(4) provides that if a corporation elects to have new section 1375(f) apply with respect to distributions made on or before the date of enactment of the bill, such distributions made on or before the 15th day of the 4th month following the close of a taxable year are treated as distributions of the corporation's undistributed taxable income for such year to the extent otherwise provided in new section 1375(f).

Deficiency assessment

Subsection (d)(5) provides that the statutory period for the assessment of any deficiency for any taxable year, to the extent it is attributable to an election under subsection (d), against the corporation filing the election or any person consenting thereto, shall not expire before the last day of the 2-year period beginning on the date on which the regulations prescribed under subsection (d) are published in the Federal Register. Thus, even though such assessment may otherwise be prevented by any law or rule of law, it may nevertheless be assessed against an electing corporation and the persons consenting thereto until the last day of such 2-year period.

Credit or refund of overpayment

Subsection (d)(6) extends the period within which credit or refund may be allowed or made of certain amounts with respect to which credit or refund is not prevented on the date of the enactment of the bill. If—

(A) credit or refund of the amount of any overpayment for any taxable year attributable to an election under subsection (d) is not prevented, on the date of enactment, by the operation of any law or rule of law, and

(B) credit or refund of the amount of such overpayment is prevented, by the operation of any law or rule of law (other than ch. 74 of the Internal Revenue Code of 1954, relating to closing agreements and compromises), at any time on or before the expiration of the 2-year period beginning on the date on which the regulations prescribed under subsection (d) are published in the Federal Register,

credit or refund of such overpayment may, nevertheless, be made, to the extent such overpayment is attributable to such election, if claim therefor is filed before the expiration of such 2-year period. Thus, subsection (d)(6) applies only to the extent of the amount with respect to which credit or refund is not prevented on the date of enactment of the bill, even though such amount may be less than the amount of any overpayment attributable to the election.

Subsection (d)(7) provides for the allowance of credit or refund of the amount of any overpayment attributable to an election under subsection (d) for any taxable year in which certain distributions were received, even though credit or refund of such overpayment is otherwise prevented on the date of enactment of the bill by the operation of any law or rule of law (other than ch. 74 of the code, relating to closing agreements and compromises). In such case, credit or refund may be allowed or made if claim therefor is filed before the expiration of the 2-year period beginning on the date on which the regulations prescribed under subsection (d) are published in the Federal Register.

These provisions apply to distributions of money which were, or were part of, one or more consecutive distributions made by a corporation after the close of a taxable year for which it was an electing small business corporation and on or before the 15th day of the 4th month following the close of such taxable year, if the total amount of such distributions was substantially the same in amount as the undistributed taxable income (as defined in sec. 1373(c) of the code) of such corporation for such year. In determining the consecutive distributions, the first distribution of money made after the close of such year must be included.

These provisions also apply to distributions of money made by a corporation after the close of a taxable year for which it was an electing small business corporation and on or before the 15th day of the 4th month following the close of such year, if it is established to the satisfaction of the Secretary of the Treasury or his delegate that such distributions were intended to be distributions of the undistributed taxable income of such corporation for such year.

No interest on deficiencies or overpayments

Subsection (d)(8) of the first section of the bill provides that no interest shall be assessed or collected on any deficiency, or allowed or paid on any overpayment, attributable to an election under subsection (d), for any period before the expiration of the 2-year period beginning on the date on which the regulations prescribed under subsection (d) are published in the Federal Register. These provisions do not prevent the assessment, collection, payment, or allowance of interest which would otherwise be lawful in respect of adjustments which are not attributable to an election under subsection (d), even though such adjustments are for the same taxable year with respect to which there is a deficiency or overpayment attributable to an election under subsection (d). For example, if for a taxable year for which the statutory period for the assessment of a deficiency has not expired, a taxpayer has a deficiency which is attributable, in part, to an election under subsection (d), and if he also has an additional amount of deficiency for such year attributable to an unrelated item, interest may be assessed and collected on the portion of the deficiency attributable to such unrelated item for the period prior to the expiration of such 2-year period.

SECTION 2. TAX IMPOSED ON CERTAIN CAPITAL GAINS OF SUBCHAPTER S CORPORATIONS

(*a*) *General rule.*—Under existing law, corporations which make an election under section 1372(a) of the code are not subject to the taxes imposed by chapter 1 of the code with respect to the taxable years of the corporation for which such election is in effect. Subsection (a) of section 2 of the bill amends subchapter S of chapter 1 of the code by adding a section 1378, which imposes a tax on such corporations under certain circumstances.

Income requirements

A tax is imposed on an electing small business corporation for a taxable year for which subsection (a) of new section 1378 applies if—

(1) the excess of the net long-term capital gain over the net short-term capital loss of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income (computed as provided in sec. 1373(d) of the code) for such year, and

(2) such taxable income for such year exceeds $25,000.

Amount of tax

Subsection (b) of new section 1378 provides that the amount of the tax imposed by subsection (a) shall be the lower of (1) an amount equal to 25 percent of the amount by which the excess of the net long-term capital gain over the net short-term capital loss of the corporation for the taxable year exceeds $25,000, or (2) an amount equal to the tax which would be imposed by section 11 of the code on the taxable income (computed as provided in sec. 1373(d) of the code) of the corporation for the taxable year if the corporation was not an electing small business corporation.

No credit shall be allowable under part IV of subchapter A of chapter 1 of the code (other than under sec. 39, relating to certain uses of gasoline and lubricating oil) against the tax imposed by new section 1378(a).

The provisions of subsections (a) and (b) of new section 1378 of the code are illustrated by the following examples:

Example (1).—X corporation, is an electing small business corporation with respect to which section 1378(a) applies for its taxable year 1967. X has an excess of net long-term capital gain over net short-term capital loss in the amount of $30,000 for 1967. However, due to an excess of deductions over other income, X's taxable income (computed as provided in sec. 1373(d) of the code) is only $15,000. Thus, although such excess of the net long-term capital gain over the net short-term capital loss ($30,000) exceeds $25,000, and exceeds 50 percent of X's taxable income ($7,500), a tax is not imposed by new section 1378(a) because X's taxable income does not exceed $25,000.

Example (2).—Assume that X in example (1) has taxable income of $40,000. (This amount includes the excess of net long-term capital gain over net short-term capital loss because such gains and losses are included in the computation of taxable income under sec. 1373(d) of the code.) In such case there is a tax imposed by new section 1378(a) of the code. The excess of the net long-term capital gain over the net short-term capital loss ($30,000) exceeds $25,000, and exceeds 50 percent of the taxable income ($20,000); and taxable income exceeds $25,000. The amount of the tax, computed under new section 1378(b)(1) of the code, is 25 percent of $5,000 or $1,250. This is lower than the amount computed under new section 1378(b)(2) of the code which is 22 percent of $40,000 plus 26 percent of $15,000, or $12,700.

Example (3).—Assume that X in example (1) has an excess of net long-term capital gain over net short-term capital loss of $125,000 and taxable income of $60,000. In such case there is a tax imposed by new section 1378(a) of the code. The amount of the tax, computed under new section 1378(b)(2) of the code, is 22 percent of $60,000 plus 26 percent of $35,000, or $22,300. This is lower than the amount computed under new section 1378(b)(1) of the code which is 25 percent of $100,000 or $25,000.

Exceptions

Subsection (c) of new section 1378 of the code provides that new section 1378(a), and thus the tax imposed by such section, shall not apply to certain electing small business corporations.

Paragraph (1) of new section 1378(c) provides that new section 1378(a) shall not apply to an electing small business corporation for any taxable year if it was an electing small business corporation for the 3 immediately preceding taxable years. Thus, if an election under section 1372(a) was in effect with respect to a corporation for its taxable years 1964, 1965, 1966, and 1967, new section 1378(a) does not apply to such corporation for its taxable year 1967 (except to the extent new sec. 1378(c)(3) may apply).

Paragraph (2) of new section 1378(c) provides that new section 1378(a) shall not apply to an electing small business corporation for a taxable year if, at the end of such year (A) it has been in existence for less than 4 taxable years, and (B) it has been an electing small business corporation for each of its taxable years. Thus, new section 1378(a) does not apply to such corporation (except to the extent new sec. 1378(c)(3) may apply) even though it does not meet the tests of new section 1378(c)(1).

Paragraph (3) of new section 1378(c) provides that if the provisions of paragraph (1) or (2) would preclude the application of new section 1378(a) for a taxable year, new section 1378(a) will nevertheless apply for such year under certain circumstances. Under the provisions of paragraph (3), new section 1378(c) will apply for a taxable year if—

(A) there is any long-term capital gain of the electing small business corporation for such year which is attributable to property acquired by it during the period beginning 36 months before the first day of such year and ending on the last day of such year;

(B) such property has a basis in the hands of such corporation determined in whole or in part by reference to the basis of any property in the hands of another corporation; and

(C) such other corporation was not an electing small business corporation throughout that part of the period beginning 36 months before the first day of the taxable year and ending on the day of the transfer during which such other corporation was in existence.

"Transfer," as used in the preceding sentence, means a transfer by such other corporation of the property the basis of which is referred to for purposes of determining the basis of the property to which such long-term capital gain is attributable. The basis of property in the hands of an electing small business corporation may, for purposes of these provisions, be determined by reference to the basis of property in the hands of another corporation whether or not such other corporation transferred such property directly to the electing small business corporation. For example, if corporation X merges into corporation Y, an electing small business corporation, pursuant to a transaction in which the basis of an asset in the hands of Y after the merger is determined by reference to the basis of such asset in the hands of X before the merger, then the basis of such asset, or any other asset for which it may be exchanged in a transaction in which gain or loss is not recognized, would be determined, for purposes of paragraph (3) of the new section 1378(c), by reference to the basis of property in the hands of X.

If new section 1378(a) would not be applicable to an electing small business corporation for a taxable year but for the provisions of paragraph (3) of new section 1378(c), then the amount of the tax imposed by new section 1378(a), shall be the lower of—

(1) the amount determined under new section 1378(b), or

(2) 25 percent of the excess of the net long-term capital gain over the net short-term capital loss attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C) of new section 1378(c)(3).

The provisions of subsection (c) of new section 1378 of the code are illustrated by the following example:

Example.—Corporation X, which uses the calendar year for its taxable year, has been an electing small business corporation continuously since its taxable year 1958. For 1967, X has an excess of $100,000 of net long-term capital gain over its net short-term capital loss, and its taxable income is $150,000. During 1967 X recognized $10,000 of long-term capital gain from the sale of property which it acquired from corporation Y on March 31, 1964, pursuant to a statutory merger of corporation Y into X on that date. Such property had a basis in the hands of X determined by reference to its basis in the hands of Y. Thus, although X meets the requirements of paragraph (1) of new section 1378(c), the tax imposed by new section 1378(a) will apply to X for 1967 unless Y was an electing small business corporation throughout the period January 1, 1964, through March 31, 1964, during which Y was in existence. If Y was not an electing small business corporation throughout such period, and if X had no capital losses for 1967 attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C) of new section 1378(c)(3), the amount of tax imposed on the income of X for 1967 by new section 1378(a) is equal to 25 percent of $10,000, or $2,500, because such amount is lower than the amount determined under new section 1378(b).

(*b*) *Related amendments.*—Paragraph (1) of section 2(b) of the bill amends the table of sections for subchapter S of chapter 1 of the code.

Paragraph (2) of section 2(b) of the bill amends section 1372(b)(1) of the code to provide an exception, for purposes of new section 1378(a), to the rule that electing small business corporations shall not be subject to the taxes imposed by chapter 1 of the code.

Paragraph (3) of section 2(b) of the bill amends section 1373(c) of the code to provide for the subtraction of the amount of the tax imposed by section 1378(a) from taxable income in determining the corporation's undistributed taxable income for a taxable year.

Paragraph (4) of section 2(b) of the bill amends section 1375(a) of the code by adding a new paragraph (3) which provides for the reduction, for purposes of such section, of the amount of the excess of an electing small business corporation's net long-term capital gain over its net short-term capital loss for a taxable year by the amount of the tax imposed by section 1378(a) for such year.

Paragraph (5) of section 2(b) of the bill amends section 46(a)(3) of the code to provide that the tax imposed by section 1378(a) for a taxable year shall not be considered in determining the liability for tax for purposes of the credit for investment in certain depreciable property.

(*c*) *Effective date.*—Subsection (c) of section 2 of the bill provides that the amendments made by section 2 of the bill shall apply with respect to taxable years of electing small business corporations beginning after the date of enactment of the bill.

SECTION 3. EXCEPTIONS TO TERMINATION OF SUBCHAPTER S ELECTION FOR CERTAIN PASSIVE INVESTMENT INCOME

(*a*) *General rule.*—Under section 1372(e)(5) of existing law, an election under section 1372(a) of the code is terminated 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 for purposes of par. (5) only to the extent of gains therefrom).

Subsection (a) of section 3 of the bill amends section 1372(e)(5) of the code by changing the heading of paragraph (5) to "passive investment income" and by dividing the paragraph into new subparagraphs (A), (B), and (C).

New subparagraphs (A) and (C) of section 1372(e)(5) contain the same general rule as existing law. However, new subparagraph (B) contains an exception to the application of such general rule. Subparagraph (C) defines the term "passive investment income" to mean the same gross receipts as are taken into account under existing law.

New subparagraph (B) of section 1372(e)(5) provides that new subparagraph (A) shall not apply to a taxable year, and thus an election under section 1372(a) of the code shall not terminate for such year by reason of section 1372(e)(5)(A) if (i) such year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year, and (ii) the amount of passive investment income for such year is less than $3,000. The taxable year in which a corporation commences the active conduct of a new trade or business is not necessarily the first year in which a corporation commences the active conduct of any trade or business. Thus, if a corporation was engaged in the active conduct of one trade or business in any prior taxable year, the taxable year in which such corporation commences the active conduct of a second or new trade or business is not the first taxable year in which such corporation commences the active conduct of any trade or business. Further, the first taxable year in which a corporation commences the active conduct of any trade or business is not necessarily the same year in which a corporation comes into existence.

(*b*) *Effective dates.*—Subsection (b) of section 3 of the bill provides that the amendment made by subsection (a) shall apply to taxable years of electing small business corporations ending after the date of enactment of the bill. Further, such amendment shall also apply with respect to taxable years beginning after December 31, 1962, and ending on or before such date of enactment, if (1) the corporation elects to have such amendment so apply, and (2) all persons (or their personal representatives) who were shareholders of such corporation at any time during any taxable year beginning after December 31, 1962, and ending on or before the date of enactment of the bill consent to such election and to the application of the amendment made by subsection (a) of section 3 of the bill. Such persons who must consent include persons who are not shareholders on the date of enactment of the bill if they were shareholders during the prescribed period. The effect of an election under these provisions is that a corporation may be an electing small business corporation whose election would, but for these provisions, have terminated under section 1372(e)(5) of the code. If such a corporation has shareholders or former shareholders whose consent is necessary to prevent a termination under section 1372(e)(1), such shareholders may consent to such election under section 1372(a) of the code at such time as the Secretary of the Treasury or his delegate shall prescribe by regulations. Further, the election by the corporation under subsection (b) of section 3 of the bill and the consents thereto shall be made at such time and in such manner as the Secretary of the Treasury or his delegate prescribes by regulations.

SECTION 4. REPEAL OF SUBCHAPTER R

This is a new section added to the bill by your committee. Under existing law (sec. 1361 of the code) unincorporated business enterprises may elect to be taxed as domestic corporations. Once an election has been made, it may not be revoked and the unincorporated business enterprise is thereafter subject to tax as a domestic corporation and the owners are treated as its shareholders, unless the election is terminated under section 1361(f) of the code by reason of a change of ownership. However, under existing law, parts III and IV of subchapter C of chapter 1 of the code are generally not applicable to unincorporated business enterprises which have made an election.

(*a*) *Status pending repeal—New elections.*—Paragraph (1) of section 4(a) of the bill amends section 1361(a) of the code to provide that no new elections under section 1361(a) may be made after the date of enactment of the bill. However, elections may be made after such date of enactment by unincorporated business enterprises which have a valid election in effect on the date of enactment but which, because of the subsequent application of the provisions of section 1361(f) (relating to change of ownership), would no longer be considered a domestic corporation but for another election under section 1361(a).

Transfer to an actual corporation

Paragraph (2) of section 4(a) of the bill amends section 1361(c) of the code by deleting a reference to section 1361(m); and paragraph (4) of section 4(a) of the bill deletes the provisions of section 1361(m). Section 4(c) of the bill provides that these amendments shall apply with respect to transactions occuring after the date of the enactment of the bill.

The effect of these amendments is to make all of the provisions of parts III and IV of subchapter C of chapter 1 of the code (relating to corporate organizations, and reorganizations, and insolvency reorganizations) applicable to a "section 1361 corporation" and its owners, in the same manner as these provisions are applicable to any true corporation and its shareholders. Thus, for example, if after the date of enactment and before January 1, 1969, the partners of an enterprise, which has a valid election in effect under section 1361(a) transfer all of the assets of such enterprise to an actual corporation and receive stock in proportion to their interests there will be no tax on the transfer of property and on the issuance of stock, under sections 368(a)(1) and 354 of the code. On the other hand, if the partners retain money or property of the enterprise, this may be treated as "boot" for purposes of section 356 of the code.

Revocation and termination of elections

Paragraph (3) of section 4(a) of the bill amends section 1361(e) of the code (relating to irrevocability of elections under section 1361(a)) to provide a reference to new section 1361(n) of the code; paragraph (5) of section 4(a) of the bill adds section 1361(n).

Paragraph (1) of new section 1361(n) provides that an election under section 1361(a) with respect to an unincorporated business enterprise may be revoked after the date of the enactment of the bill by the proprietor of such enterprise or by all of the partners owning an interest in such enterprise on the date on which the revocation is made. The revocation shall be made in such manner as the Secretary of the Treasury or his delegate may prescribe by regulations. The revocation will be effective on the date on which it is made unless the revocation specifies a later effective date and such enterprise shall not be considered a domestic corporation for any period on or after the effective date of the revocation. The section 1361 corporation and its owners shall be treated as if the corporation had distributed its assets in a complete liquidation on the effective date of the revocation, unless such treatment is inappropriate because of the applicability of provisions of the code relating to corporate organizations and reorganizations. Such applicability can result, for example, from a subsequent transfer of assets to an actual corporation.

Paragraph (2) of new section 1361(n) provides that if a revocation under paragraph (1) of an election under section 1361(a) with respect to any unincorporated business enterprise is not effective on or before December 31, 1968, such election shall terminate on January 1, 1969, and such enterprise shall not be considered a domestic corporation for any period on or after January 1, 1969. Of course, if an election with respect to an enterprise terminates on or before December 31, 1968, as a result of the provisions of section 1361(f), and another election under section 1361(a) with respect to such enterprise is not made on or before such date, section 1361(n) is not applicable to such enterprise. If an election is terminated under the provisions of paragraph (2) of new section 1361(n), the section 1361 corporation and its owners shall be treated in the same manner as if a revocation had been made under paragraph (1) of section 1361(n), effective on January 1, 1969.

(*b*) *Repeal of subchapter R.*—Section 4(b) of the bill repeals subchapter R of chapter 1 of the code, and all references thereto contained in the code, effective January 1, 1969.

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

Internal Revenue Code of 1954

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter A—Determination of Tax Liability

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Part IV—Credits Against Tax

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SUBPART B—RULES FOR COMPUTING CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

SEC. 46. AMOUNT OF CREDIT.

(a) DETERMINATION OF AMOUNT.—

(1) GENERAL RULE.—The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

(2) LIMITATION BASED ON AMOUNT OF TAX.—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

(A) so much of the liability for tax for the taxable year as does not exceed $25,000, plus

(B) 25 percent of so much of the liability for tax for the taxable year as exceeds $25,000.

(3) LIABILITY FOR TAX.—For purposes of paragraph (2), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

(A) section 33 (relating to foreign tax credit),

(B) section 35 (relating to partially tax-exempt interest), and

(C) section 37 (relating to retirement income).

For purposes of this paragraph, any tax imposed for the taxable year by section 531 (relating to accumulated earnings tax) [or by], section 541 (relating to personal holding company tax), *or section 1378 (relating to tax on certain capital gains of subchapter S corporations)* shall not be considered tax imposed by this chapter for such year.

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[1] [Subchapter R—Election of Certain Partnerships and Proprietorships as to Taxable Status

[Sec. 1361. Unincorporated business enterprises electing to be taxed as domestic corporations.

[SEC. 1361. UNINCORPORATED BUSINESS ENTERPRISES ELECTING TO BE TAXED AS DOMESTIC CORPORATIONS.

[(a) GENERAL RULE.—Subject to the qualifications in subsection (b), an election may be made, in accordance with regulations prescribed by the Secretary or his delegate, not later than 60 days after the close of any taxable year of a proprietorship or partnership owning an unincorporated business enterprise, by the proprietor or all the partners, owning an interest in such enterprise at any time on or after the first day of the first taxable year to which the election applies or of the year described in subsection (f), to be subject to the taxes described in subsection (h) as a domestic corporation for such year and subsequent years. *No election (other than an election referred to in subsection (f)) may be made under this subsection after the date of the enactment of this sentence.*

[(b) QUALIFICATIONS.—The election described in subsection (a) may not be made with respect to an unincorporated business enterprise unless at all times during the period on or after the first day of the first taxable year to which the election applies or of the year described in subsection (f), as the case may be, and on or before the date of election—

[(1) such enterprise is owned by an individual, or by a partnership consisting of not more than 50 individual members;

[(2) no proprietor or partner having more than a 10 percent interest in profits or capital of such enterprise is a proprietor or a partner having more than a 10 percent interest in profits or capital of any other unincorporated business enterprise taxable as a domestic corporation;

[(3) no proprietor or partner of such enterprise is a nonresident alien or a foreign partnership; and

[(4) such enterprise is one in which capital is a material income producing factor, or 50 percent or more of the gross income of such enterprise consists of gains, profits, or income derived from trading as a principal or from buying and selling real property, stock, securities, or commodities for the account of others.

[(c) CORPORATE PROVISIONS APPLICABLE.—Under regulations prescribed by the Secretary or his delegate, an unincorporated business enterprise as to which an election has been made under subsection (a), shall[, except as provided in subsection (m),] be considered a corporation for purposes of this subtitle, except chapter 2 thereof, with respect to operation, distributions, sale of an interest, and any other purpose; and each owner of an interest in such enterprise shall be considered a shareholder thereof in proportion to his interest.

[(d) LIMITATION.—A partner or proprietor of an unincorporated business enterprise as to which an election has been made under subsection (a) shall not be considered an employee for purposes of section 401(a) (relating to employees' pension trusts, etc.) other than an employee within the meaning of section 401(c)(1) (relating to self-

[1] The repeal of subch. R is to be effective Jan. 1, 1969.

employed individuals), or for purposes of section 405 (relating to qualified bond purchase plans) other than an employee described in section 405(f).

[(e) ELECTION IRREVOCABLE.—Except as provided in [subsection (f)] *subsections (f) and (n)*, the election described in subsection (a) shall be irrevocable—

[(1) with respect to an enterprise as to which such election has been made and the proprietor or partners of such enterprise; and

[(2) any unincorporated successor to the business of such enterprise and the proprietor or partners of such successor.

[(f) CHANGE OF OWNERSHIP.—In any year in which the electing proprietor or partners have an interest of 80 percent or less in profits and capital of an enterprise described in subsection (e), such enterprise shall not be considered a domestic corporation for such year or for subsequent years unless the proprietor or partners of such enterprise make a new election in accordance with subsection (a).

[(g) CONSTRUCTIVE OWNERSHIP.—For purposes of subsection (f), the ownership of an interest shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) thereof.

[(h) IMPOSITION OF TAXES.—The unincorporated business enterprise as to which an election has been made under subsection (a) shall be subject to—

[(1) the normal tax and surtax imposed by section 11,

[(2) the accumulated earnings tax imposed by section 531, and

[(3) the alternative tax for capital gains imposed by section 1201.

[(i) PERSONAL HOLDING COMPANY INCOME.—

[(1) EXCLUDED FROM INCOME OF ENTERPRISE.—There shall be excluded from the gross income of the enterprise as to which an election has been made under subsection (a) any item of gross income (computed without regard to the adjustments provided in section 543(b)(3) or (4)) if, but for this paragraph, such item (adjusted, where applicable, as provided in section 543(b)(3) or (4)) would constitute personal holding company income (as definied in section 543(a)) of such enterprise.

[(2) INCOME AND DEDUCTIONS OF OWNERS.—Items excluded from the gross income of the enterprise under paragraph (1), and the expenses attributable thereto, shall be treated as the income and deductions of the proprietor or partners (in accordance with their distributive shares of partnership income) of such enterprise.

[(3) DISTRIBUTION.—If—

[(A) the amount excluded from gross income under paragraph (2) exceeds the expenses attributable thereto, and

[(B) any portion of such excess is distributed to the proprietor or partner during the year earned,

such portion shall not be taxed as a corporate distribution. The portion of such excess not distributed during such year shall be considered as paid-in surplus or as a contribution to capital as of the close of such year.

[(j) COMPUTATION OF TAXABLE INCOME.—In computing the taxable income of an unincorporated business enterprise as to which an election has been made under subsection (a)—

[(1) a reasonable deduction shall be allowed for salary or compensation to a proprietor or partner for services actually rendered; and

[(2) there shall be allowed as deductions only such items properly allocable to the operation of the business of such enterprise, except deductions allocable to the proprietor or partners under subsection (i)(2).

[(k) DISTRIBUTIONS OTHER THAN IN LIQUIDATION.—Except as provided in subsection (l), a distribution with respect to a proprietorship or partnership interest by an enterprise as to which an election has been made under subsection (a), other than a distribution of personal holding company income under subsection (i)(3), shall be treated as a corporate distribution in accordance with part I of subchapter C of this chapter.

[(l) DISTRIBUTIONS IN LIQUIDATION.—A distribution in partial or complete liquidation with respect to a proprietorship or partnership interest by an enterprise as to which an election has been made under subsection (a), shall be treated as a corporate liquidation in accordance with part II of subchapter C of this chapter.

[2] [(m) ORGANIZATIONS AND REORGANIZATIONS.—An enterprise as to which an election has been made under subsection (a) shall not be considered a corporation, nor shall the proprietor or partners of such enterprise be considered shareholders, for purposes of parts III and IV of subchapter C of this chapter (relating to corporate organizations, and reorganizations, and insolvency reorganizations) except in the case of—

[(1) a contribution of property, constituting either paid-in surplus or a contribution to capital, on which gain or loss is recognized; and

[(2) the organization of an enterprise as to which the election described in subsection (a) is made for its first taxable year.]

[(*n*) *REVOCATION AND TERMINATION OF ELECTIONS.*—

[(*1*) *REVOCATION.*—*An election under subsection* (*a*) *with respect to an unincorporated business enterprise may be revoked after the date of the enactment of this subsection by the proprietor of such enterprise or by all the partners owning an interest in such enterprise on the date on which the revocation is made. Such enterprise shall not be considered a domestic corporation for any period on or after the effective date of such revocation. A revocation under this paragraph shall be made in such manner as the Secretary or his delegate may prescribe by regulations.*

[(*2*) *TERMINATION.*—*If a revocation under paragraph* (*1*) *of an election under subsection* (*a*) *with respect to any unincorporated business enterprise is not effective on or before December 31, 1968, such election shall terminate on January 1, 1969, and such enterprise shall not be considered a domestic corporation for any period on or after January 1, 1969.*]

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[2] Subsec. (m) is stricken out effective with respect to transactions occurring after the date of the enactment of the bill.

Subchapter S—Election of Certain Small Business Corporations as to Taxable Status

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SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

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(b) EFFECT.—If a small business corporation makes an election under subsection (a), then—

(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter (*other than the tax imposed by section 1378*) and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

(2) with respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

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(e) TERMINATION.—

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[(5) PERSONAL HOLDING COMPANY INCOME.—An election under subsection (a) made by a small business corporation 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 for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.]

(5) PASSIVE INVESTMENT INCOME.—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation 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 passive investment

income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means 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).

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SEC. 1373. CORPORATION UNDISTRIBUTED TAXABLE INCOME TAXED TO SHAREHOLDERS.

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(c) UNDISTRIBUTED TAXABLE INCOME DEFINED.—For purposes of this section, the term "undistributed taxable income" means taxable income (computed as provided in subsection (d)) minus *the sum of (1) the tax imposed by section 1378(a) and (2)* the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a)(2).

SEC. 1375. SPECIAL RULES APPLICABLE TO DISTRIBUTIONS OF ELECTING SMALL BUSINESS CORPORATIONS.

(a) CAPITAL GAINS.—

(1) TREATMENT IN HANDS OF SHAREHOLDERS.—The amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1373(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for such taxable year. For purposes of this paragraph, such excess shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

(2) DETERMINATION OF SHAREHOLDER'S PRO RATA SHARE.—A shareholder's pro rata share of such excess for any taxable year shall be an amount which bears the same ratio to such excess as the amount of dividends described in paragraph (1) includible in the shareholder's gross income bears to the entire amount of dividends described in paragraph (1) includible in the gross income of all shareholders.

(3) Reduction for tax imposed by section 1378.—For purposes of paragraphs (1) and (2), the excess of an electing small business corporation's net long-term capital gain over its net short-term capital loss for a taxable year shall be reduced by an amount equal to the amount of the tax imposed by section 1378(a) on the income of such corporation for such year.

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(d) Distributions of Undistributed Taxable Income Previously Taxed to Shareholders.—

(1) Distributions not considered as dividends.—An electing small business corporation may distribute, in accordance with regulations prescribed by the Secretary or his delegate, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

(2) Shareholder's net share of undistributed taxable income.—For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to—

(A) the sum of the amounts included in the gross income of the shareholder under section 1373(b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by

(B) the sum of—

(i) the amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and

(ii) all amounts previously distributed during the taxable year and all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which [under paragraph (1)] *under subsection (f) or paragraph (1) of this subsection* were considered distributions which were not dividends.

[(e) Certain Distributions After Close of Taxable Year.—

[(1) In general.—For purposes of this chapter, if—

[(A) a corporation makes a distribution of money to its shareholders on or before the 15th day of the third month following the close of a taxable year with respect to which it was an electing small business corporation, and

[(B) such distribution is made pursuant to a resolution of the board of directors of the corporation, adopted before the close of such taxable year, to distribute to its shareholders all or a part of the proceeds of one or more sales of capital assets, or of property described in section 1231(b), made during such taxable year.

such distribution shall, at the election of the corporation, be treated as a distribution of money made on the last day of such taxable year.

[(2) SHAREHOLDERS.—An election under paragraph (1) with respect to any distribution may be made by a corporation only if each person who is a shareholder on the day the distribution is received—

[(A) owns the same proportion of the stock of the corporation on such day as he owned on the last day of the taxable year of the corporation preceding the distribution, and

[(B) consents to such election at such time and in such manner as the Secretary or his delegate shall prescribe by regulations.

[(3) MANNER AND TIME OF ELECTION.—An election under paragraph (1) shall be made in such manner as the Secretary or his delegate shall prescribe by regulations. Such election shall be made not later than the time prescribed by law for filing the return for the taxable year during which the sale was made (including extensions thereof) except that, with respect to any taxable year ending on or before the date of the enactment of the Revenue Act of 1964, such election shall be made within 120 days after such date.]

(f) DISTRIBUTIONS WITHIN 2½-MONTH PERIOD AFTER CLOSE OF TAXABLE YEAR.—

(1) DISTRIBUTIONS CONSIDERED AS DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME.—Any distribution of money made by a corporation after the close of a taxable year with respect to which it was an electing small business corporation and on or before the 15th day of the third month following the close of such taxable year to a person who was a shareholder of such corporation at the close of such taxable year shall be treated as a distribution of the corporation's undistributed taxable income for such year, to the extent such distribution (when added to the sum of all prior distributions of money made to such person by such corporation following the close of such year) does not exceed such person's share of the corporation's undistributed taxable income for such year. Any distribution so treated shall, for purposes of this chapter, be considered a distribution which is not a dividend, and the earnings and profits of the corporation shall not be reduced by reason of such distribution.

(2) SHARE OF UNDISTRIBUTED TAXABLE INCOME.—For purposes of paragraph (1), a person's share of a corporation's undistributed taxable income for a taxable year is the amount required to be included in his gross income under section 1373(b) as a shareholder of such corporation for his taxable year in which or with which the taxable year of the corporation ends.

(3) ELECTION UNDER SUBSECTION (e).—Paragraph (1) shall not apply to any distribution with respect to which an election under subsection (e) applies.

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SEC. 1378. TAX IMPOSED ON CERTAIN CAPITAL GAINS.

(a) General Rule.—If for a taxable year of an electing small business corporation—

(1) the excess of the net long-term capital gain over the net short-term capital loss of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and

(2) the taxable income of such corporation for such year exceeds $25,000,

there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

(b) Amount of Tax.—The tax imposed by subsection (a) shall be the lower of—

(1) an amount equal to 25 percent of the amount by which the excess of the net long-term capital gain over the net short-term capital loss of the corporation for the taxable year exceeds $25,000, or

(2) an amount equal to the tax which would be imposed by section 11 on the taxable income (computed as provided in section 1373(d)) of the corporation for the taxable year if the corporation was not an electing small business corporation.

No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

(c) Exceptions.—

(1) In general.—Subsection (a) shall not apply to an electing small business corporation for any taxable year if the election under section 1372(a) which is in effect with respect to such corporation for such taxable year has been in effect for the 3 immediately preceding taxable years.

(2) New corporations.—Subsection (a) shall not apply to an electing small business corporation if—

(A) it has been in existence for less than 4 taxable years, and

(B) an election under section 1372(a) has been in effect with respect to such corporation for each of its taxable years.

(3) Property with substituted basis.—If—

(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year.

(B) any long-term capital gain is attributable to property acquired by the electing small business corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an electing small business corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed 25 percent of the excess of the net long-term capital gain over the net short-term capital loss attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).

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