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Incentives for Emerging Growth Companies to Revoke S Election

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I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA) added §481(d) and §1371(f) which extend the time frame for shareholders of S corporations that convert to C corporation status to continue to receive tax-free distributions of money following a revocation of the S election.[1] Under §481(d)(2), a corporation, the S election of which was terminated, is known as an eligible terminated S corporation (ETSC). The period after the S election termination generally is the post-termination transition period (PTTP).[2] The PTTP extended by §1371(f) for an ETSC is the ETSC period.[3]

The last date to revoke the S election to benefit from ETSC status is December 21, 2019.[4] The statutory due date for terminating S corporation status by revocation could not be extended.[5] However, proposed Treasury regulations released on November 4, 2019 (''Proposed Regulations'')[6] allow tax planning opportunities to ease transition for an ETSC from S corporation status to subchapter C.[7]

II. TRANSITION OF AN S CORPORATION TO SUBCHAPTER C STATUS

Prior to enactment of §1371(f), cash distributions by a corporation after the PTTP would have been sub-

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[1] Formally titled ''An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,'' Pub. L. No. 115-97, 131 Stat. 2155, §13543 (Dec. 22, 2017). All section references are to the Internal Revenue Code of 1986, as amended (''Code''), and the regulations thereunder, unless otherwise stated.

[2] *See* §1377(b) (defining generally a PTTP).

[3] *See* §1371(f); Prop. Reg. §1.1371-1(a)(2)(vii). *See also* §481(d)(2). Section 481(d)(1) allows an ETSC to take into account any adjustments in computing taxable income of the corporation that are required solely by reason of a change in accounting method attributable to revocation of S election under §1371(f) ratably over six tax years beginning with the year of the change. §481(a)(2), §481(d)(1), §418(d)(2)(A)(ii), §1371(f). §481(d) and §1371(f) apply only to those entities that convert from S corporation to C corporation status. An entity formed as a limited liability company under State law (LLC) may elect to be taxed as an S corporation by filing IRS Form 2553. However, an LLC that revokes the S election and elects to be taxed as a partnership or a disregarded entity on IRS Form 8832 would not be an ETSC. See §481(d), §7701(a)(3) (defining the term ''corporation'' for purposes of the Code); §7701(a)(4) (describing generally a domestic corporation or partnership); §301.7701-3(a) (providing that an eligible entity with a single owner may elect to be classified as an association or to be disregarded as an entity separate from its owner, in which case would not be treated as a corporation to which the definition of a domestic entity under §7701(a)(4) applied).''

[4] *See* §481(d)(2)(A)(ii).

[5] *See generally* H. Rpt. 115-466, at 384 (2017) (conference report for the TCJA does not mention allowing extension of the specified two-year period for an S corporation to convert to C corporation status).

[6] *See* REG-131071-18, 84 Fed. Reg. 60,011, 60,016 (Nov. 7, 2019) (generally would apply to taxable years beginning after the rules appear as final in the Federal Register; however, corporations may choose to apply the rules in Prop. Reg. §1.316-2, §1.481-5, §1.1371-1, §1.1371-2, and §1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before the proposed rules appear as final in the Federal Register and with respect to which the period described in §6511(a) has not expired; if the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently); Prop. Reg. §1.481-6, §1.1371-1(e), §1.1371-2(d), §1.1377-3.

[7] *See* §301–§385 (subchapter C provisions).

ject to dividend treatment and inclusion in income by shareholders under §301(c) and §316. Thus, any accumulated adjustments account (AAA) remaining after the PTTP, the distribution of which would have been tax-free to a shareholder or taxable as capital gain, would have been forfeited.[8] S corporations pass-through the tax consequences of items of income, loss, deduction or credit to their shareholders.[9]

Growth-stage companies may prioritize reinvestment of corporate earnings over distributions to shareholders. A §199A temporary, qualified business income (QBI) deduction may offset a potential tax liability for S corporation shareholders.[10] However, the deduction would be limited to certain types of income and would phase out at higher income levels for some taxpayers.[11] In addition, higher tax would apply to built-in gain on a disposition of new assets during the first five years as an S corporation.[12]

Thus, there would be limited benefit of pass-through taxation under subchapter S. Instead, S corporation shareholders may defer recognition of income from corporate earnings. Consistently, a lower tax rate under the TCJA at the corporate level would apply to operating income of the S corporation.[13]

Conversion to a C corporation requires a case-by-case evaluation taking into account individual, economic and tax considerations of stakeholders. Two additional tax factors are noted.

First, once the entity is in a position to distribute corporate earnings, it may not revert to pass-through taxation for five years following termination of the S election.[14] During the minimum five-year period, shareholder distributions would be subject to two tiers of taxation.[15]

Thus, conversion to a C corporation would benefit emerging growth companies (EGCs), which are organized as small business corporations.[16] Generally, an S corporation is a small business corporation for which an election under §1362(a) is made. In turn, an S corporation is a domestic corporation, which may not have more than 100 shareholders and may not have shareholders who are nonresident aliens or persons other than U.S. citizens, residents, certain estates, trusts or tax-exempt organizations.[17] EGCs may be seeking funding beyond initial ''friends and family'' rounds. Thus, S corporation status, which may expose individual investors to potential liability and restrict possible equity structures, may not be advisable.[18]

Second, state corporate income tax consequences must be taken into account. Depending on the jurisdiction in which the entity was incorporated or conducts business activities, S corporation status may not be recognized, thus minimizing the potential discrepancy in tax liability.[19] However, some states may recognize S corporation status. The diminished economic

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[8] *See* §481(d), §1368(e), §1371(e), §1371(f), §1377(b)(1)(A); *Tomseth v. United States*, No. 6:17-cv-02017-AA, 2019 BL 367373, 2019 U.S. Dist. LEXIS 166939 *9–10 (D. Or. Sept. 27, 2019), *appealed*, No.19-35979 (Nov. 22, 2019) (finding in dicta that §1371(f) compatible with the general rule that that AAA funds expire at the end of the PTTP; further stating in dicta that after the expiration of the statutory two-year window for revoking an S election, a corporation will not meet the requirements of §481(d) and will revert to the default rule of no AAA following the PTTP; holding, *inter alia*, that, for tax years prior to TCJA, the AAA of corporations resets to zero after the PTTP rather than being available to corporations that re-elected subchapter S form).

[9] §1366; Reg. §1.1366-1(a).

[10] *See generally* §199A(a)(1) (generally allowing a deduction for a taxable year of individuals or pass-through entities of the lesser of QBI or 20% of taxable income of the taxpayer for the taxable year, with certain modifications and adjustments; the deduction is also available for REIT income); §199A(f) (deduction applicable at S corporation shareholder level); §199A(i) (deduction not applicable to taxable years beginning after December 31, 2025).

[11] *See* §199A (b)(3)(B) (phase-in income thresholds for certain taxpayers to qualify for the deduction), §199A(b)(1) (generally limiting deduction to income from qualified trade or business (''QTB''), or certain REIT dividends, cooperative dividends or publicly traded partnership income), §199A(d) (defining QTB), §199A(e) (defining REIT and other type of income eligible for a deduction).

[12] *See* §11(b), §1374.

[13] *See* §11(b). Taxable income of an S corporation, other than certain separately stated items and subject to certain special rules, is computed in the same manner as the taxable income of an individual and is passed through to S corporation shareholders. §1363(b), §1366(a). A C corporation, like an S corporation, may deduct reasonable compensation paid to shareholders who are employees of the corporation. *See generally* §162(a)(1). Depending on the management structure of the entity, the allowance of a deduction further would reduce discrepancy in potential tax liability between the two tax structures.

[14] §1362(g).

[15] *See* §1, §11, §301, §316.

[16] *See* §1361(a); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §101, 126, Stat. 307 (2012) (defining an EGC generally as a company with less than $1.07 billion, as adjusted for inflation in 2017 (every five years), in total annual gross revenues during the most recently completed fiscal year for purposes of scaled capital formation, disclosure and registration requirements under the Securities Act of 1933, as amended, 15 U.S.C.S. §§77a et seq. (''Securities Act'') and the Securities and Exchange Act of 1934, as amended, 15 U.S.C.S. §§78a et seq. (''Exchange Act'')); Securities Act §2(a)(19); Exchange Act §3(a)(80) (respective EGC definitions).

[17] §1361(a)(1), §1361(b)(1), §1361(c)(2), §1361(c)(3). S corporation stock may be held by a disregarded single-member LLC owned by an eligible S corporation shareholder. *See* PLR 9745017.

[18] An S corporation may not have more than one class of stock, but voting rights of common stock generally are disregarded for purposes of this rule. *See* §1361(b)(1), §1361(c)(4).

[19] *See, e.g.,* N.Y. Tax Law §209(1) (imposing general corporation tax on net income base of corporation, and not recognizing S corporations).

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benefits and tax savings associated with C corporation status must be weighed against subchapter S.

Converting to a C corporation would have precluded S corporation shareholders from removing earnings out of corporate solution tax-free outside the PTTP. During the PTTP, or generally, one year after revoking the S election,[20] the AAA would be available as a source of cash distributions that would reduce the adjusted basis of shareholders in their stock.[21] Any excess distributions would be taxable to shareholders at the lower capital gain income tax rates.[22]

After the end of the PTTP, any remaining AAA would no longer be available.[23] Thus, any cash distributed to shareholders would be subject to corporate income tax and to individual income tax at ordinary income rates.[24] Section 1371(f) permits S corporations that relinquished pass-through taxation within two years of the effective date of the TCJA to distribute corporate earnings to shareholders tax-free to the extent of their stock basis and available AAA.[25]

III. GENERAL REQUIREMENTS FOR APPLICABILITY OF §1371(f) TO DISTRIBUTIONS

Certain requirements must be met for a former S corporation to qualify as an ETSC following the end of the PTTP.[26] First, the corporation must have been an S corporation on December 21, 2017, the day before the enactment date of TCJA.[27] Second, the corporation must revoke the S election during the two-year period beginning on the effective date of TCJA.[28]

Third, S corporation shareholders must be both identical and in the same proportions on the effective date of the TCJA and the revocation date.[29] Transfers of S corporation stock between an S corporation shareholder and certain wholly owned or controlled entities would not violate the shareholder identity requirement.[30] Similarly, certain changes in the tax status of an existing S corporation shareholder will not cause the corporation to forgo its status as an ETSC.[31]

IV. FAVORABLE TREATMENT OF SHAREHOLDERS UNDER PROPOSED REGULATIONS

A. Effective Date of S Election Revocation May Be Postponed

The Proposed Regulations provide a taxpayer favorable interpretation of the statutory two-year period for revoking the S election to benefit from additional tax-free distributions.[32] A corporation must revoke the S election by December 21, 2019 to qualify as an ETSC.[33] However, the effective date of the election may be postponed for any subsequent taxable year.[34] The delay allows time for the terms and conditions of a private equity financing round or a stock purchase to be negotiated, and for the financing or a stock sale to close following the revocation.

In addition, historical AAA is determined as of the date a revocation is effective.[35] Thus, between the revocation date and the effective date of termination, the AAA as a source of subsequent distributions not subject to income tax, may continue to increase. Therefore, private equity investors may receive cash distributions from the ETSC in subsequent tax years without consequences of income inclusion.

Moreover, there is a possibility of rescinding a prospective revocation of S election prior to the effective date of revocation.[36] The Proposed Regulations do not contain any specific tax avoidance or anti-abuse rules

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[20] *See* §1377(b)(1)(A). *But see* §1377(b)(1)(B) (a determination pursuant to an audit after S election termination, which adjusts certain items of income, loss or deduction of former S corporation during the S period possibly extending the PTTP); Prop. Reg. §1.1371-2(a)(1), §1.1371-2(a)(3), §1.1371-2(b) (defining an audit PTTP as the PTTP described in §1377(b)(1)(B) and an intervening audit PTTP as the audit PTTP during an ETSC period providing that an ETSC period resumes immediately following the conclusion of an intervening audit PTTP, if the ETSC continues to have an AAA balance greater than zero).

[21] *See* §1368(c), §1368(e), §1371(e)(1).

[22] *See* §1(h), §1368(c)(2), §1371(e)(1).

[23] *See* §1368(e), §1371(e), §1377(b)(1)(B); *supra* n. 8 and accompanying text.

[24] *See* §1, §11.

[25] *See* §481(d)(2)(a)(ii), §1371(f).

[26] *See* §481(d)(2).

[27] §481(d)(2)(A)(i); Prop. Reg. §1.481-5(b)(1); Preamble to REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019).

[28] §481(d)(2)(A)(ii); Prop. Reg. §1.481-5(b)(2); Preamble to REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019).

[29] §481(d)(2)(B); Prop. Reg. §1.481-5(b)(3). *See also* REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019) (discussion of shareholder identity requirement).

[30] *See* Prop. Reg. §1.481-5(c)(1), §1.481-5(c)(2).

[31] *See* Prop. Reg. §1.481-5(c)(3), §1.481-5(c)(4). In order for §1371(f) to apply, the former S corporation must have AAA. *See generally* §1368(e)(1), §1371(f), and discussion below.

[32] *See* §1362(d)(1)(D); Reg. §1.1362-2(a)(2)(ii);REG-131071-18, 84 Fed. Reg. 60,012 (Nov. 7, 2019).

[33] §481(d)(2)(A)(ii); Prop. Reg. §1.481-5(b)(2); REG-131071-18, 84 Fed. Reg. at 60,017 (Nov. 7, 2019) (referring to December 21, 2019 as the end of the specified two-year period).

[34] §1362(d)(1)(D); Reg. §1.1362-2(a)(2)(ii); Preamble to REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019) (explaining the scope of the revocation requirement in light of applicability of §1362(d)(1)(D) and the Treasury regulations thereunder).

[35] Prop. Reg. §1.1371-1(a)(2)(ix).

[36] *See* Reg. §1.1362-2(a)(4).

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related to rescinding a prospective revocation prior to the effective date in connection with §1371(f). Subject to potential limitations, an S corporation may rescind a revocation of S election pursuant §481(d)(2)(A)(ii) after December 21, 2019.[37]

B. Existing or New Shareholders May Receive Qualified Distributions

The Proposed Regulations rejected a no-newcomer rule under §1371(f).[38] Pursuant to this rule, only the shareholders existing as of the date of S election termination[39] would have been eligible to receive distributions out of AAA,[40] a corporate-level account.[41] The no-newcomer rule applies to distributions during the PTTP.[42] The Proposed Regulations eliminated the no-newcomer rule that applied during a PTTP.[43] Likewise, during the ETSC period, any shareholder or transferee of ETSC stock may receive distributions out of the AAA.[44]

Eligibility of new owners of stock to receive qualified distributions[45] are consistent with a taxpayer-favorable ETSC shareholder identity requirement.[46] The §481(d)(2)(B) rule does not apply after termination of S election,[47] even if the revocation is prospective.[48] Thus, following revocation, purchasers or transferees of ETSC stock may receive tax-free distributions limited to allocated AAA and any adjusted basis of the shareholder.[49]

C. S Corporation Stock May Be Returned to Qualify as an ETSC

An example in Proposed Regulations highlights a special application of the shareholder identity requirement, not clarified in the Preamble.[50] The example is distinguished from the rule permitting related-party transfers or changes in shareholder tax status.[51] The permitted transactions are exceptions to the shareholder identity requirement, rather than applications of the general rule.[52]

In the example, current stockholders restore interests in the S corporation to prior owners after the effective date of a retroactive revocation (January 1) but before the date of the actual revocation (March 15 of the same tax year).[53] The return transfer of the stock to a previous shareholder achieves the same ownership and in the same proportions as on December 22, 2017.[54] Therefore, the shareholder identity rule under §481(d)(2)(B) is met.[55]

Section 481(d)(2)(B) requires only that the share ownership is the same and in identical proportions on two distinct dates. One is the date prior to the TCJA effective date, or December 22, 2017. The second is the actual date of revocation of the S election.[56] Section 481(d)(2)(B) and the Proposed Regulations do not require shareholders to maintain ownership identity between the two dates or after revocation.[57]

Thus, as illustrated in the example, S corporation shareholders may transfer shares back to prior owner to satisfy the identity rule any time between December 22, 2017, and revocation. Therefore, stock ownership may change to meet the identity requirement after the effective date of termination only if the S election is revoked retroactively. Yet, the example heading does not say the stock must be restored prior to the revocation date.

Instead, the title of the example is, ''Restoration of interests prior to end of PTTP.''[58] A PTTP generally is a year after the last day of the last tax year as an S

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[37] See discussion below.

[38] Preamble to REG-131071-18, 84 Fed. Reg. at 60,013 (Nov. 7, 2019) (discussing rejecting no-newcomer rule).

[39] An S election may be terminated either voluntarily with consent of shareholders by revocation, inadvertently, or by the IRS for failure to meet subchapter S requirements. *See* §1362(d).

[40] §1371(e)(1); Preamble to REG-131071-18, 84 Fed. Reg. at 60,013 (Nov. 7, 2019). *See* Reg. §1.1377-2(b). *Cf.* Preamble to REG-131071-18, 84 Fed. Reg. at 60,016, 60,025 (Nov. 7, 2019).

[41] §1368(e)(1).

[42] *See* Reg. §1.1377-2(b).

[43] *Compare* Reg. §1.1377-2(b) *with* Prop. Reg. §1.1377-2(b); REG-131071-18, 84 Fed. Reg. 60,016, 60,025 (Nov. 7, 2019) (deleting last sentence, which limited applicability of AAA distributions during the PTTP to S corporation shareholders existing as of the date of S election revocation).

[44] Preamble to REG-131071-18, 84 Fed. Reg. at 60,013, 60,016, 60,025 (Nov. 7, 2019). The added benefit of the elimination of the provision is that an ETSC does not have to track shareholders for qualified distribution purposes during the PTTP. *See* REG-131071-18, 84 Fed. Reg. at 60,017 (Nov. 7, 2019).

[45] REG-131071-18 84 Fed. Reg. at 60,013, 60,016, 60,025 (Nov. 7, 2019).

[46] *See* §481(d)(2)(B); Prop. Reg. §1.481-5(b)(3).

[47] *See* §481(d)(2)(B); Prop. Reg. §1.481-5(b)(3); REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019).

[48] *See* §1362(d)(1)(D); Reg. §1.1362-2(a)(2)(i); REG-131071-18, 84 Fed. Reg. 60,012 (Nov. 7, 2019).

[49] §1368(c)(1), §1371(f); Prop. Reg. §1.1371-1(b)(2)(i), §1.1371-1(b)(2)(iii), §1.1377-2 (deleting no-newcomer rule).

[50] Prop. Reg. §1.481-5(d)(1)(iii).

[51] *See* Prop. Reg. §1.481-5(c).

[52] *Id.*

[53] Prop. Reg. §1.481-5(d)(1)(iii).

[54] *Id.*

[55] §481(d)(2)(B); Prop. Reg. §1.481-5(d)(1)(iii).

[56] §481(d)(2)(B); Prop. Reg. §1.481-5(b)(3)(i), §1.481-5(b)(3)(ii).

[57] §481(d)(2)(B); Prop. Reg. §1.481-5(b)(3)(ii); *see* REG-131071-18, 84 Fed. Reg. at 60,012, 60,013 (Nov. 7, 2019) (explaining shareholder identity requirement as being evaluated only on two dates; rejecting no-newcomer rule).

[58] Prop. Reg. §1.481-5(d)(1)(iii).

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corporation.[59] By contrast, the S election may be revoked retroactively to the beginning of a tax year at maximum two-and-a-half months from the beginning of the tax year.[60] Therefore, the PTTP of a former S corporation by definition must end after the revocation date.

The latest revocation date under §481(d) is December 21, 2019.[61] The Proposed Regulations do not suggest that interests may be restored before the expiration of a PTTP but after the specified two-year period under the statute. Therefore, the restoration of interests rule allows shareholders to adjust the stock holdings to replicate December 22, 2017, ownership and then revoke the S election retroactively. However, the revocation needs to occur by December 21, 2019.

V. REQUIREMENTS AND EFFECT OF A REVOCATION OF S ELECTION

A. Validity of Revocation of S Election

A valid revocation of S election requires consent of shareholders holding more than one-half of the issued and outstanding shares of S corporation stock on the date of revocation.[62] The corporation must file a revocation statement with the IRS with the required shareholder consents attached.[63] A revocation of S election effective retroactively on the first day of a taxable year must be filed with the IRS by the 15th day of the third month of that taxable year.[64] A prospective revocation of S election must be filed on or before the effective date.[65]

B. Related Filing Requirements

An S corporation files an annual return on IRS Form 1120-S and shareholder statements on Schedules K-1 for Form 1120-S.[66] A revocation of S election may be effective after the first day of a tax year of an S corporation. In this instance, the former S corporation must file an annual return on Form 1120-S and a return on IRS Form 1120 for the short tax years as an S corporation and as a C corporation, respectively.[67]

[59] §1377(b)(1)(A); Reg. §1.1377-2(a)(1)(i).

[60] §1362(d)(1)(C); Reg. §1.1362-2(a)(2)(i).

[61] *See* §481(d)(2)(B); REG-131071-18, 84 Fed. Reg. at 60,017 (Nov. 7, 2019) (specifying end of statutory two-year period under §481(d)(2)(B)).

[62] §1362(d)(1)(B); Reg. §1.1362-2(a)(1).

[63] Reg. §1.1362-6(a)(3)(i).

[64] Reg. §1.1362-2(a)(2)(i).

[65] Reg. §1.1362-2(a)(2)(ii).

[66] *See* §6037.

[67] §1362(e).

C. Rescission of a Revocation of S Election

In general, an S corporation may rescind a revocation of an S election at any time before the revocation becomes effective.[68] Each shareholder who consented to revocation and each person who became a shareholder after revocation and before the rescission must consent to the rescission.[69] To rescind a revocation, the S corporation must file a rescission statement with the same IRS service center as the one with which the S corporation filed the revocation.[70]

The possibility of filing a rescission may protect taxpayers from unfavorable tax consequences of the initial decision to revoke an S election. However, general anti-abuse or tax avoidance principles may apply to a rescission.[71] Further guidance from Treasury and the IRS may clarify the parameters of a valid rescission in connection with obtaining ETSC status.

VI. TAXATION OF DISTRIBUTIONS BY AN ETSC UNDER §1371(f)

A. Taxation of Distributions by an S Corporation During an S Period

Distributions by an S corporation during the S period are treated as being made first from its AAA.[72] An S corporation's AAA is a tax account, the value of which is increased or decreased similarly as a shareholder's basis in S corporation stock.[73] Thus, the AAA generally is increased by taxable income and decreased by related losses, deductions, and certain nondeductible expenses of the S corporation.[74] Distributions by an S corporation under §1368(b) or §1368(c)(1), which reduce the adjusted basis in the stock or are subject to exchange treatment, further decrease the AAA.[75]

[68] Reg. §1.1362-2(a)(4).

[69] *Id.*

[70] Reg. §1.1362-6(a)(4)(i).

[71] *See, e.g., McClelland Farm Equipment Co. v. United States*, 601 F.2d 365, 367–368 (8th Cir. 1979) (stating that, ''By limiting the period for filing Subchapter S elections in section 1372(c), Congress 'intended to require the corporation to make the election before it could predict its profitability for the year with any certainty.' This limitation serves to prevent taxpayers from using Subchapter S solely as a tax avoidance mechanism. In keeping with this congressional purpose, courts have construed the time limitations of section 1372(c) and related regulations strictly against taxpayers submitting election documents to the IRS after the running of the Subchapter S election period''; holding an election form was timely filed by the taxpayer during the statutory period) (citations omitted.)

[72] §1368(c)(1); Reg. §1.1368-1(a)(1).

[73] §1367, §1368(e)(1).

[74] Reg. §1.1368-2(a).

[75] Reg. §1.1368-2(a)(3)(iii).

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A distribution from the AAA is tax-free to the extent of the basis of the recipient shareholder in the stock of the S corporation.[76] The portion of the distribution that exceeds the adjusted basis in the stock is treated as capital gain.[77] Distributions in excess of the S corporation's AAA are taxed as dividends to the extent of its earnings and profits (E&P).[78] Remaining distributions exceeding E&P, which are not treated as a dividend, are capital gain.[79] Therefore, a distribution of property by an S corporation with respect to its stock is taxable as a dividend only after the AAA has been exhausted.[80]

E&P generally is taxable, undistributed income of a corporation calculated separately[81] with some adjustments to reflect amounts that exceed a return of investment.[82] An S corporation may have E&P from operating previously as a C corporation or from a reorganization or other transaction involving the application of subchapter C.[83] Generally, a distribution of property by a C corporation with respect to its stock reduces its E&P.[84] In contrast to the AAA, which is a tax account, E&P is an accounting concept.[85]

Unlike with a C corporation's E&P, unless subchapter C applies to an S corporation with respect to any transaction,[86] only the portion of a distribution that is treated as a dividend under §1368(c)(2) reduces the S corporation's E&P.[87] A dividend under §1368(c)(2) is a distribution by an S corporation after its AAA has been exhausted.[88] Therefore, absent an election,[89] during the S period, a distribution by an S corporation will reduce its E&P only if the AAA balance has reached zero.[90]

B. Taxation of Distributions by a Corporation During the PTTP

Cash distributions during the PTTP[91] are governed by §1371(e).[92] During the PTTP, a distribution of money first reduces the adjusted basis of a shareholder's stock in the corporation, to the extent AAA is available.[93] Similarly as with distributions during the S period, a corporation may elect, with the consent of all affected shareholders, to distribute E&P during the PTTP first.[94] The election under §1371(e)(2) would result in distributions being subject to tax treatment under subchapter C.[95]

C. Taxation of Distributions by an ETSC During the ETSC Period

Cash distributions during the ETSC period under §1371(f) may be qualified distributions, excess qualified distributions, or nonqualified distributions.[96] E&P during the ETSC period may be accumulated E&P (AE&P) or current E&P.[97] A qualified distribution is a distribution by an ETSC during the ETSC period, to which, but for §1371(f) and accompanying Proposed Regulations, §301 would apply.[98] The portion of a qualified distribution sourced from AAA or AE&P, re-

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[76] §1368(c)(1).

[77] §301(c), §1368(a), §1368(b)(2), §1368(c)(1).

[78] §301(c)(1), §316(a), §1368(a), §1368(c)(2). The Code does not define E&P. *See* §316(a). But the Code and Treasury regulations set forth rules for adjustments to or computation of E&P. *See* §312; Reg. §1.312-1–§1.312-15 and §1.316-1(a)(1). Broadly, E&P are used to calculate taxable dividends, and thus, are intended to ''approximate a corporation's power to make distributions, which are more than just a return of investment.'' *See* §301(c), §316(a); *Juha v. Commissioner*, T.C. Memo 2012-68, *12, n.12 (Mar. 13, 2012) (citations omitted).

[79] §301(c)(3)(A).

[80] §301(c)(1), §1368(a), §1368(b), §1368(c)(1), §1368(c)(2).

[81] *See* §61; *Juha v. Commissioner*, T.C. Memo 2012-68 *15 (Mar. 13, 2012); Reg. §1.312-6(a), §1.312-6(b) (E&P calculated using the same accounting method as the method used to calculate taxable income; among the items entering into the E&P are all items includible in gross income under §61).

[82] §1371(a) (providing that, to the extent not inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders); *See supra* n. 78 and accompanying text. *See generally* §301–§385 (subchapter C provisions applicable to C corporations), §1361–§1379 (subchapter S provisions applicable to S corporations).

[83] *See* §316(a), §1371(a), §1371(c)(2).

[84] §312(a).

[85] *See* §312, §1367, §1368(e)(1); *supra* n. 78 and accompanying text.

[86] §1371(c)(1), §1371(c)(2).

[87] §1368(c)(2), §1371(c)(3).

[88] §1368(c)(2).

[89] §1368(e)(3) (election with the consent of all affected shareholders to distribute earnings first for a taxable year during the S period); §1368(e)(2) (S period is defined as a continuous period, excluding taxable years beginning before January 1, 1983, during which the corporation was an S corporation); Reg. §1.1368-1(f)(2) (election to distribute AE&P first by an S corporation for any taxable year). *Cf.* §1371(e)(2).

[90] *See* §1368(c)(2).

[91] §1377(b)(1)(A) (definition of a PTTP generally as the period of one year following the last date of the last tax year of the corporation as an S corporation).

[92] §1371(e)(1).

[93] *Id.*

[94] §1371(e)(2), §1377(b)(1)(A) (definition of a PTTP generally as the period of one year following the last date of the last tax year of the corporation as an S corporation); Temp. Reg. §18.1371-1 (1984) (election by a corporation requiring consent of each shareholder to treat all distributions of money during a PTTP as being made out of E&P until it is eliminated).

[95] *See* §301(c), §316, §1371(e)(2).

[96] Prop. Reg. §1.1371-1(a)(2)(vii), §1.1371-1(a)(2)(xi), §1.1371-1(a)(2)(xii).

[97] §316(a)(1), §316(a)(2); Prop. Reg. §1.1371-1(a)(2)(iii), §1.1371-1(a)(2)(v).

[98] §301, §316, §1371(f); Prop. Reg. §1.1371-1(a)(2)(xii).

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spectively, generally is the amount that is in the same ratio as the AAA bears to the AE&P.[99]

If an S corporation did not have E&P[100] prior to the effective date of its S election revocation, cash distributions would be sourced from the AAA.[101] Sourcing distributions from the AAA, as opposed to E&P accumulated after termination of S corporation status, would give eligible shareholders the benefit of receiving cash tax-free to the extent of the respective basis of each shareholder in its ETSC stock.[102]

An ETSC may have AE&P as of the effective date of the S election revocation.[103] In that case, some of the distribution amounts would be sourced from AE&P of the ETSC.[104] Those cash distributions would be taxable to recipient shareholders as dividends under subchapter C.[105]

After each distribution, the respective AAA and AE&P accounts of the corporation would be rebalanced or eliminated.[106] For purposes of determining the portion of the distribution sourced from AAA or AE&P, if AE&P is reduced to zero, the entire distribution is sourced from any remaining AAA.[107] Once the AAA has been eliminated, distributions by the ETSC are treated as dividends subject to income inclusion rules under §301(c) and §316.[108]

VI. CONCLUSION

S corporation shareholders still may take action to secure the tax benefits of qualified distributions upon revocation of an S election, which may be effective past the statutory revocation date. S corporations that are currently considering C corporation form or are in the process of obtaining additional financing would benefit from additional administrative relief in the proposed amendment to §1377 regulations. Even though new shareholders would be added to the equity roster, a no-newcomer rule would not apply. Thus, new investors purchasing stock of a former S corporation would be able to receive certain qualified distributions tax-free.

Accordingly, shareholders as of the TCJA effective date and the revocation date would benefit from tax-free treatment of qualified distributions. Furthermore, if the original shareholders sell their S corporation stock after the revocation date but before the revocation becomes effective, transferees of the stock would be able to receive qualifying distributions. In addition, current S corporation shareholders may act now to restore identical share ownership as on December 22, 2017, prior to filing a revocation statement. S corporations considering ETSC benefits must revoke the S election by December 21, 2019. However, absent further guidance and subject to general anti-abuse and tax avoidance principles under the Code that may apply, an S corporation may rescind a prospective revocation of an S election after December 21, 2019, prior to the effective date of the revocation.

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[99] §1371(f); Prop. Reg. §1.1371-1(b)(2)(i), §1.1371-1(b)(3)(i) (specific formulas for sourcing from AAA and AE&P based on administrative interpretation of §1371(f)). *See also* REG-131071-18, 84 Fed. Reg. at 60,012 (Nov. 7, 2019) (Preamble explanation of ETSC proration).

[100] In addition to AE&P, an ETSC may have previously taxed income prior to January 1, 1983, the effective date of a statutory amendment that repealed the provision. *See* Reg. §1.1368-1(d)(2), §1.1368-1(f)(2)(ii).

[101] *See id.*; Prop. Reg. §1.1371-1(b)(2).

[102] *See* Prop. Reg. §1.1371-1(b)(2)(iii).

[103] *See* Prop. Reg. §1.1371-1(a)(2)(x).

[104] §1371(f); Prop. Reg. §1.1371-1(b)(3).

[105] §301(c)(1), §316; Prop. Reg. §1.1371-1(b)(3)(iii).

[106] Prop. Reg. §1.1371-1(b)(2)(ii), §1.1371-1(b)(3)(ii).

[107] Prop. Reg. §1.1371-1(b)(3)(iv).

[108] §301(c)(1), §316, §1371(f); Prop. Reg. §1.1371-1(a)(2)(viii), §1.1371-1(b)(2)(ii), §1.1371-1(c). These additional distributions taxed as dividends are excess qualified distributions, to the extent not sourced from the AAA once the ETSC proration is reapplied, or nonqualified distributions. Prop. Reg. §1.1371-1(a)(2)(viii), §1.1371-1(b)(2)(xi), §1.1371-1(b)(4), §1.1371-1(c).

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