



TOURO UNIVERSITY
JACOB D. FUCHSBERG LAW CENTER
Where Knowledge and Values Meet

Touro Law Review

Volume 5 | Number 2

Article 2

1989

IRD and S Corporations

Gregory V. Gadarian

Jonathan G. Blattmachr

Follow this and additional works at: <https://digitalcommons.tourolaw.edu/lawreview>



Part of the [Business Organizations Law Commons](#), [Estates and Trusts Commons](#), [Taxation-Federal Commons](#), and the [Taxation-Federal Estate and Gift Commons](#)

Recommended Citation

Gadarian, Gregory V. and Blattmachr, Jonathan G. (1989) "IRD and S Corporations," *Touro Law Review*: Vol. 5: No. 2, Article 2.

Available at: <https://digitalcommons.tourolaw.edu/lawreview/vol5/iss2/2>

This Article is brought to you for free and open access by Digital Commons @ Touro Law Center. It has been accepted for inclusion in Touro Law Review by an authorized editor of Digital Commons @ Touro Law Center. For more information, please contact lross@tourolaw.edu.

TOURO LAW REVIEW

Vol. 5, No. 2



Spring 1989

IRD AND S CORPORATIONS

Gregory V. Gadarian* and Jonathan G. Blattmachr**

* Gregory V. Gadarian is a partner in the Tucson law firm of Freund & Gadarian. He received his B.A. from Northwestern University, his J.D. (cum laude) from the Northwestern University School of Law, and his LL.M. in Taxation from New York University. Mr. Gadarian was admitted to the State Bar of Arizona in 1984, the District of Columbia Bar in 1980, and the Florida Bar in 1975. From 1978-80, Mr. Gadarian was a Legislation Attorney on the staff of the Joint Committee on Taxation, U.S. Congress. Prior to that, he was an Attorney-Advisor to Judge Cynthia H. Hall of the U.S. Tax Court. Since 1981, Mr. Gadarian's practice has concentrated on estate planning, partnership, and corporate tax matters.

** Jonathan G. Blattmachr is a member of the Alaska, California, and New York Bars and a partner in the law firm of Milbank, Tweed, Hadley & McCloy. He is a former Chairperson of the Trusts & Estates Law Section of the New York State Bar Association and is a chair or a former chair of certain other committees of the New York State Bar Association and the American Bar Association. Mr. Blattmachr is a Fellow of the American College of Probate Counsel, an Academician of the International Academy of Estate and Trust Law, and a Fellow of the New York State Bar Foundation. He is author or co-author of several articles and two books on estate planning topics. He is the Editor of *Probate Notes*, published by the American College of Probate Counsel, and *The Chase Review*, published by the Chase Manhattan Bank (N.A.).

INTRODUCTION

In recent years the use of S corporations¹ has increased significantly because of various changes in the Internal Revenue Code (the Code).² Although the general tax consequences of making an S election have been explored by several commentators,³ one area which largely has been overlooked in discussions involving S corporations is the extent to which income in respect of a decedent⁴ (IRD) will arise

1. An S corporation is a small business corporation which elects such status pursuant to I.R.C. §§ 1361(a), 1362(a).

[T]he term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—

- (A) have more than 35 shareholders,
- (B) have as a shareholder a person . . . who is not an individual,
- (C) have a nonresident alien as a shareholder, and
- (D) have more than 1 class of stock.

I.R.C. § 1361(b)(1).

2. All references to the Code are to the Internal Revenue Code of 1986, as amended, except where noted otherwise.

The Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (codified, as amended, in scattered statutes of 26 U.S.C.), simplified the rules relating to the operation of S corporations and removed various eligibility restrictions on S corporation status. In addition, the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 237-41, 96 Stat. 324, 511-21 (codified, as amended, in scattered sections of 26 U.S.C.), provided, to some degree, parity between the pension benefits available to self-employed taxpayers, employee-shareholders of S corporations, and employee-shareholders of C corporations. More recent changes made by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified, as amended, in scattered statutes of 26 U.S.C.), have increased the use of S corporations. Reductions of both the individual tax rate, *id.* § 101, 100 Stat. at 2096-99, and the corporate tax rate, *id.* § 601, 100 Stat. at 2249, along with the repeal of the "General Utilities" doctrine, *id.* § 631-33, 100 Stat. at 2269-82, have led to more corporations electing to become S corporations. *See* General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) (no taxable gain to corporation when it distributed shares of another corporation's stock to shareholders as dividend because assets were not used to discharge indebtedness and the distribution was not a sale).

3. *See, e.g.*, L. BRAVENAC, *FEDERAL TAXATION OF S CORPORATIONS AND SHAREHOLDERS* (2d ed. 1988); T. NESS & E. VOGEL, *TAXATION OF THE CLOSELY HELD CORPORATION* (4th ed. 1986); D. SCHENK, *FEDERAL TAXATION OF S CORPORATIONS* (1987); E. STUEBER, *TAX PLANNING TECHNIQUES FOR THE CLOSELY HELD CORPORATION* (3d ed. 1987).

4. I.R.C. § 691.

The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

- (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;
- (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

in connection with the ownership of S corporation stock by a decedent. This article focuses on that issue.

Generally, IRD refers to amounts which would have been taxed to the decedent as gross income had he or she lived, but were not properly includible in the final or a prior income tax return of the decedent.⁵ The right to collect an item of IRD may be includible in the decedent's gross estate⁶ and, if so, is included at its fair market value.⁷ However, the item is denied the change in income tax basis to its estate tax value which generally is available to other assets acquired from or passed from a decedent.⁸ Hence, the full amount of the IRD which is collected is includible in the gross income of the taxpayer who collects the item, although that taxpayer is entitled to an income tax deduction equal to estate tax attributable to the inclusion in the gross estate of the right to receive the IRD.⁹

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

I.R.C. § 691(a)(1).

5. Treas. Reg. § 1.691(a)-1(b) (as amended in 1965). IRD includes—

- (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
- (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and
- (3) Income to which the decedent had a contingent claim at the time of his death.

Id.

6. I.R.C. § 691(a)(1)(A).

7. I.R.C. § 2033. A decedent's gross estate includes the value of all property to the extent of the decedent's interest at the date of death. *Id.* The "fair market value" of stocks and securities which are not publicly traded, such as those of closely held corporations, is "determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." *Id.* § 2031(b).

8. I.R.C. § 1014(a) provides that the basis will be equal to the asset's fair market value on the decedent's date of death unless the estate has elected, under I.R.C. § 2032, to value the property for estate tax purposes on the alternative valuation date, in which case the basis equals fair market value on the alternative valuation date. However, section 1014(c) provides that this rule "shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691."

9. Treas. Reg. § 1.691(c)-1(a) (as amended in 1966).

A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

Id.

I. TAXATION OF S CORPORATIONS AND THEIR SHAREHOLDERS

A. General Principles

An S corporation generally is not subject to federal corporate income tax.¹⁰ Instead, each item of income, loss, deduction, and credit is attributed to the corporation's shareholders substantially as though the shareholders had received or expended those items directly.¹¹ Each shareholder's pro rata share of the items is taken into account in the shareholder's taxable year in which the corporation's year ends.¹² In the case of the death of a shareholder, the shareholder's pro rata share is taken into account on the shareholder's final return.¹³ Items from the portion of the corporation's taxable year, after the shareholder's death, are taken into account by the estate or the person acquiring the stock from the deceased shareholder.¹⁴

A shareholder may deduct his or her share of losses and deductions only to the extent of that shareholder's adjusted basis in the stock and his or her adjusted basis in any indebtedness of the corporation owed to the shareholder. Any item of loss disallowed under this rule is carried over to the corporation's succeeding taxable year and is allowable to the extent the shareholder's basis in the stock or debt is increased in such succeeding year.¹⁵

A shareholder's adjusted basis in the stock will initially be equal to the amount of money contributed to the corporation or the amount paid for the stock.¹⁶ Generally, that adjusted basis will be increased by any additional money contributed to the corporation

10. I.R.C. § 1363(a) ("Except as otherwise provided in this subchapter an S corporation shall not be subject to the taxes imposed by this chapter."). However, in certain cases, capital gains and other income can be taxed to an S corporation. See I.R.C. § 1374.

11. I.R.C. § 1366 (pass-thru of items to shareholders). Although the income, losses, credits, and deductions of an S corporation are attributed to the shareholders, the Code does not give the shareholders any right to receive those items directly.

12. I.R.C. § 1366(a)(1); *see also* § 444(a) (S corporation may elect a taxable year other than calendar year).

13. I.R.C. § 1366(a)(1).

14. An S corporation may elect to split its tax year into two in any taxable year of the corporation during which any shareholder terminates his or her initial shareholder interest in the corporation. I.R.C. § 1377(a)(2); *see* Treas. Reg. § 18.1377-1 (1983). It is not clear, however, whether this provision applies if termination results from the death of a shareholder.

15. I.R.C. § 1366(d).

16. I.R.C. § 1012. *But see* § 1015 (basis of property acquired by gift and transferred in trust is the same as it was in the hands of the donor unless the fair market value on the date of transfer is less than such basis; then the donee's basis is the fair market value on the date of the gift); § 1014 (basis of property acquired from a decedent shall be the property's fair market value on the date of death).

and the shareholder's share of any item of income. The basis in the stock normally will be decreased, but not below zero, by the amount of the shareholder's pro rata share of items of loss and deduction, expenditures of the corporation which are neither properly deductible nor properly chargeable to capital account, and the amount of any distributions to the shareholder which are not includible in the shareholder's income.¹⁷

B. Effect of Revenue Ruling 64-308

In the thirty years since enactment of Subchapter S, only one published case or ruling has dealt with the relationship of S corporations and the IRD rules. In Rev. Rul. 64-308,¹⁸ the decedent shareholder died prior to the end of the corporation's taxable year. The Service ruled that the undistributed taxable income of an S corporation did not constitute income in respect of a decedent.¹⁹ Consequently, the

17. I.R.C. § 1367(a).

18. 1964-2 C.B. 176.

19. In Rev. Rul. 64-308, the Internal Revenue Service held that none of the income generated in an S corporation (whether earned before or after a shareholder's death) could constitute income in respect of a decedent. That conclusion was a prerequisite for the ruling's ultimate conclusion that no deduction was permitted under section 691(c) for the estate tax paid on the inclusion in the estate of the right to the undistributed income of the S corporation.

The right to the income in respect of a decedent may be includible in the decedent's estate and IRD may, therefore, be subject to both estate taxation as well as income taxation. To avoid full "double regime" of taxes, section 691(c) provides that the taxpayer who must report the IRD in gross income is entitled to an income tax deduction for the amount of estate tax which is generated by including the right to the IRD in the estate.

Although section 691(c) provides for a deduction for the estate tax paid, it does not wholly vitiate the impact of two tax regimes. As a general rule, rather than receiving the section 691(c) deduction, taxpayers will be better off economically if the property "receives" an income tax-free change in basis to its estate tax value, which is provided for property acquired from, or passing from, a decedent, other than IRD.

Simply because property does not receive a step-up in basis to its estate tax value under section 1014(a) does not necessarily mean that it is IRD which would entitle its "collector" to the income tax deduction provided for under section 691(c). In several cases, property will be denied the change in basis under section 1014(a) and, yet, be subject to income tax at the time of collection without constituting IRD. As Rev. Rul. 64-308 indicates, if the property is not IRD, no section 691(c) deduction will be allowed and the property may be subject to two full layers of tax. Ironically, the taxes could approach or exceed the value of the property subject to tax.

It may be that the full double tax regime was the intended effect of Rev. Rul. 64-308. The ruling does not hold that the inherent income tax liability built into the S corporation at the time of the shareholder's death was "forgiven." There is a strong implication in the ruling that the inheritors of the stock would receive a tax-free change in basis in the stock as provided for under section 1014(a). At the same time, the ruling strongly suggests that the inherent income tax liability on account of income accrued through the shareholder's death was not "forgiven." This latter suggestion, coupled with the disallowance of a section 691(c) deduction, leads to

decedent was not entitled to a section 691(c) deduction.²⁰ Under section 1373(b), as in effect in 1964, the undistributed taxable income of an S corporation was includible in the income of the shareholders owning stock in the corporation on the last day of the corporation's taxable year.²¹ The Internal Revenue Service stated that "[s]ection 691 of the code does not apply to dividends declared on stock owned by a taxpayer but unpaid at [the shareholder's] death if [the shareholder] die[d] before the record date."²² The Service concluded that the shareholder/decedent had no right to the income since he was not a shareholder on the last day of the corporation's taxable year, and it held that the item was income to the decedent's estate under section 1373, but was not IRD.²³

the conclusion that such income would be subject to two full layers of tax. As a consequence, from the taxpayer's perspective, the ruling may have an adverse effect.

20. I.R.C. § 691(c)(1)(A).

A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a)(1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a)(1).

Id.

21. I.R.C. § 1373 (1958), omitted by Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (codified, as amended, in scattered sections of 26 U.S.C.), provided in part:

(a) General Rule.—The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) Amount Included in Gross Income.—Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year.

Id.

22. Rev. Rul. 64-308, 1964-2 C.B. 176, 177. Generally, a corporation will declare a dividend a few days before the date on which it records the names of its shareholders who are entitled to the dividend. The persons who are the shareholders when this recording occurs, rather than the persons holding the shares when the dividend is declared, are the record date owners who receive the dividend.

23. *Id.* The ruling concluded that the decedent's estate was not entitled to a section 691(c) deduction for estate taxes attributable to undistributed taxable income of the corporation. *But cf.* *Sun First Nat'l Bank v. United States*, 607 F.2d 1347, 1354-55 (Ct. Cl. 1979) (installment note obligations owned by a trust under state law were owned by grantor for federal tax purposes and, therefore, on grantor's death, trust included those items in its gross income and was allowed under section 691(c) to deduct estate tax attributable to that income), *acq. in result sub nom.* *Southeast Bank v. United States*, 676 F.2d 660 (Ct. Cl. 1982).

Rev. Rul. 64-308 may be interpreted as holding that no item of S corporation income will be treated as IRD.²⁴ However, the enactment of the Subchapter S Revision Act of 1982²⁵ (the Act) may cast doubt on this conclusion. Although neither the Act nor its legislative history refers to the ruling or to IRD, the Act specifically adopts a conduit approach for the treatment of income and deductions arising from S corporations.²⁶ In fact, the conduit approach adopted for S corporations is based upon the rules governing the treatment of partnership income, gain, loss, and deductions.²⁷

II. INCOME IN RESPECT OF A DECEDENT

A. Partnership IRD Rules

In general, there are three classes of IRD which may arise with respect to a deceased partner. The first is payments made by the partnership to the deceased partner's successor in liquidation of the deceased partner's interest in the partnership.²⁸ The second is the portion of the distributive share of income of the partnership "which is attributable to the period ending with the date of [the partner's] death and which is taxable to [that partner's] successor" in interest.²⁹ The final class includes the portion of the income from the estate's or successor's ownership of the decedent's partnership interest which is attributable to certain items that would have been items of IRD if they had been held by the decedent individually.³⁰

24. See Blattmachr, *Income in Respect of a Decedent: Income Taxation of Estates and Trusts*, 175 PLI 39, 43-44 (1987).

25. Pub. L. No. 97-354, 96 Stat. 1669 (codified, as amended, in scattered sections of 26 U.S.C.).

26. See I.R.C. § 1366, 96 Stat. at 1677-79.

27. See H.R. REP. NO. 97-826, 97th Cong., 2d Sess., reprinted in 1982 U.S. CODE & ADMIN. NEWS 3253, 3255.

28. I.R.C. § 736(a).

Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

Id.; see I.R.C. § 753 which expressly provides that section 736(a) payments are considered IRD.

29. Treas. Reg. § 1.753-1(b) (1960); see Treas. Reg. § 1.706-1(c)(3)(V) (as amended in 1973).

30. *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336, 1342, 1345 (1970) (partnership interest in collections of accounts receivable), *aff'd*, 444 F.2d 90 (8th Cir. 1971); see also *Woodhall v. Commissioner*, 454 F.2d 226, 229 (9th Cir. 1972) ("Accounts receivable of a

B. Appropriate IRD Rules for S Corporations

One of the general purposes of the Act was to eliminate certain disparities in the tax treatment of S corporations and partnerships.³¹ As a result of the changes made in Subchapter S under the Act, it appears appropriate to consider whether any of the three classes of income in respect of a deceased partner now may be considered to constitute income in respect of a deceased shareholder of an S corporation.

The first class of items of income in respect of a deceased partner is section 736(a) payments. The Code expressly provides for these payments to constitute IRD.³² The Code contains no similar provision with respect to payments in liquidation of a deceased shareholder's interest in the corporations. Hence, it would seem that section 736(a)-type payments made with respect to an S corporation are not IRD.

The second class of IRD for a deceased partner referred to above deals with an issue similar to that addressed in Rev. Rul. 64-308.³³ The partnership rules set forth in the Treasury Regulations treat income attributable to the period before the decedent's death as IRD.³⁴ In Rev. Rul. 64-308, the Service ruled the portion of the Subchapter S income attributable to the period the decedent owned the stock was not IRD.³⁵ The Service's reasoning for its conclusion appears to be that, because the decedent was not a shareholder of record, he was not entitled to any dividend at his death.³⁶ Under well-settled principles, a dividend declared before the death of a shareholder is not IRD where the shareholder dies before the record date.³⁷ None of the amendments to the S corporation rules appears to change the result of Rev. Rul. 64-308, which is based on Supreme

partnership shared in by a successor in interest of a deceased partner constituted income in respect of a decedent.").

31. See H.R. REP. NO. 97-826, 97th Cong., 2d Sess. 5-6 (1982).

32. I.R.C. § 753.

33. See *supra* notes 19-27 and accompanying text.

34. See *supra* note 29 and accompanying text.

35. See *supra* note 23 and accompanying text.

36. Rev. Rul. 64-308, 1964-2 C.B. at 177 ("The decedent must be identified as the owner of the right to the income [i.e., the dividend] at his death.").

37. Estate of Putnam v. Commissioner, 324 U.S. 393 (1945); see also Boyle v. United States, 355 F.2d 233, 235 (3d Cir. 1965) (section 691 did not apply to dividend arrearages), *rev'd on other grounds*, 380 F.2d 973 (3d Cir. 1967).

Court precedent.³⁸ Hence, even after the Act, it seems that income earned through the shareholder's death is not IRD.

Indeed, one provision, if applicable, would foreclose the possibility that income earned through the shareholder's death is IRD. Under section 1362(e)(3), the corporation's year can be "split" by election. If this election were made, assuming it applies in cases of transfers by death,³⁹ the income through the shareholder's death would be attributed to the shareholder and not to any successor. Because this income would be included on the shareholder's final income tax return, it could not, by definition, be IRD.

That leaves the third class of IRD, which was judicially created, dealing with certain income attributable to partnership assets that would have been IRD items if held directly by the decedent. In both *Estate of Riegelman v. Commissioner*⁴⁰ and *United States v. Ellis*,⁴¹ it was held that payments from a partnership after the death of a general partner constituted IRD.⁴² This determination was confirmed, at least with respect to accounts receivable, by two cases decided subsequent to the significant revisions of the partner and partnership tax rules made by the Internal Revenue Code of 1954.⁴³ Both *Quick v. Commissioner*⁴⁴ and *Woodhall v. Commissioner*⁴⁵ rest their conclusions, in large measure, on the legislative history to the partner and partnership revisions of the Internal Revenue Code of 1954.⁴⁶ The legislative history strongly suggests that Congress intended a deceased partner's share of the accounts receivable be

38. Rev. Rul. 64-308, 1964-2 C.B. at 177 ("section 691 of the Code does not apply to dividends declared on stock owned by a taxpayer but unpaid at his death if he dies before the record date") (citing *Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945)).

39. It is not totally clear that I.R.C. § 1377 applies to transfers effected by death. It appears to apply to any transfer, however, and, therefore, would seem to apply to a transfer effected by death. See *supra* note 14 and accompanying text.

40. 253 F.2d 315 (2d Cir. 1958).

41. 264 F.2d 325 (2d Cir. 1959).

42. *Id.* at 327 (where partnership income was derived principally from insurance policy commissions, payments to be made to partner's widow for ten years following partner's death were considered IRD); *Riegelman*, 253 F.2d at 319 (payments to deceased partner's estate were IRD where partnership agreement provided that, upon partner's death, his estate was entitled to share of profits on work completed before death and attributable to work completed after death on matters in process at death).

43. See *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972); *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1971).

44. 54 T.C. 1336 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1971).

45. 454 F.2d 226 (9th Cir. 1972).

46. *Woodhall*, 454 F.2d at 228; *Quick Trust*, 54 T.C. at 1343-44.

treated as IRD.⁴⁷ Therefore, the courts' conclusions appear to be well-founded.⁴⁸

The question then is whether the conclusions reached in *Quick* and *Woodhall* with respect to deceased partners should extend to deceased shareholders of S corporations. The answer may depend upon the breadth of those conclusions as well as fundamental differences between partnerships and S corporations. The holdings of both courts appear to be narrow—i.e., only accounts receivable are IRD.⁴⁹ Although some commentators suggest that any partnership item is IRD if it would be IRD if owned directly by the decedent,⁵⁰ the better view is that they should not be treated as IRD. IRD is the *right* or entitlement to income.⁵¹ No matter how great the efforts of the decedent in creating the income, there can be no IRD without the right to receive the items of income.⁵² There is no right under partnership law for the partner to receive a distribution of income except where the partner is in a position to force a distribution of the partnership's right to the partners.⁵³ This general rule is true even with respect to accounts receivable and inventory. Nevertheless, these two items and payments described in section 736(a)⁵⁴ were targeted by Congress for IRD treatment.⁵⁵ The extent to which partnership items other than accounts receivable and inventory are IRD

47. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 70-71, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4097; S. REP. NO. 1622, 83d Cong., 2d Sess. 99, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4730.

48. It is uncertain whether the conclusions of the *Quick Trust* and *Woodhall* courts are limited to unrealized receivables, as is suggested in congressional reports; see *supra* note 47. Certain statements by the courts strongly suggest that they are so limited. See, e.g., *Quick Trust*, 54 T.C. at 1343 ("[A]n examination of the legislative purpose reinforces our reading of section 751, dealing with unrealized receivables and inventory items . . ."). Earlier decisions, e.g., *United States v. Ellis*, 264 F.2d 325 (2d Cir. 1959) and *Estate of Riegelman v. Commissioner*, 253 F.2d 315 (2d Cir. 1958), also suggest narrow holdings.

49. *Woodhall*, 454 F.2d at 229; *Quick Trust*, 54 T.C. at 1345.

50. See, Englebrecht & Bolling, *Income in Respect of a Decedent and the Deceased Partner*, 17 MEM. ST. U.L. REV. 329, 346 (1987); Gunn, *Federal Tax Problems of Income in Respect of Deceased Partner*, 3 J. PARTNERSHIP TAX'N 23, 24-25 (1986).

51. I.R.C. § 691(a).

52. See *Keck v. Commissioner*, 415 F.2d 531 (6th Cir. 1969) (where prior to decedent's death he had agreed to the sale of assets of three affiliated corporations in which he owned stock, but the sale was not consummated until after his death, liquidation distributions to his widow were not IRD). Some cases dealing with personal service type income suggest a contrary view, but these decisions appear to be limited solely to such specific circumstances. See, e.g., *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619 (1983), *aff'd*, 752 F.2d 1128 (6th Cir. 1985).

53. This could occur if the right is granted pursuant to the partnership agreement.

54. See *supra* note 28 and accompanying text.

55. See *supra* note 47 and accompanying text.

remains uncertain. Nevertheless, it seems that even these items are not income in respect of a deceased shareholder of an S corporation for two reasons.

First, if the partnership cases are limited to accounts receivable and inventory, they should not be extended to S corporations. Section 751 of the Code has express and detailed rules dealing with these items in partnerships, and its legislative history expressly provides for them to be IRD.⁵⁶ No comparable rules are contained in the Subchapter S provisions.

Second, even if the partnership cases extend to all items which would be IRD if directly held by the decedent, it seems that such an extension should not apply to S corporations. Nothing in the legislative history to the Act suggests that Rev. Rul. 64-308 was being overruled.⁵⁷ On the contrary, the reasoning in the ruling, which drew its support from *Estate v. Putman*,⁵⁸ seems as applicable now as it did when originally made. That Supreme Court decision held that dividends declared on stock owned by a taxpayer but unpaid at death cannot be IRD if the shareholder dies before the record date.⁵⁹

A major counter-argument might be that, presently, shareholders of S corporations are taxed much more like partners than when Rev. Rul. 64-308 was issued.⁶⁰ But, many differences between partnerships and S corporations remain, some of which are tangentially, if not directly, related to this issue. First, the Subchapter S provisions have no counterparts to sections 736(a) and 753, which expressly direct that payments made to a deceased partner's successor in liquidation of the deceased partner's interest in the partnership are IRD.⁶¹ Arguably, in the absence of such a provision, payments made in liquidation of a deceased shareholder's interest in an S corporation (presumably, a buy-back of stock by the corporation itself) should not be IRD. Second, in general, no part of a deceased partner's share of income earned through death, even if received by the partner and expended before death, is includible on the final income tax return of the partner. Instead, it is included on the return of the partner's successor in interest and it is treated as IRD.⁶² In contrast to the part-

56. *Id.*

57. See S. REP. NO. 640, 97th Cong., 2d Sess., reprinted in 1982 U.S. CODE & ADMIN. NEWS 3253.

58. 324 U.S. 393 (1945).

59. *Id.* at 399.

60. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (codified, as amended, in scattered statutes of 26 U.S.C.); see H.R. REP. NO. 97-826, *supra* note 27.

61. See *supra* notes 29, 32, and accompanying text.

62. See I.R.C. §§ 736(a), 753; Rev. Rul. 68-215, 1968-1 C.B. 312.

nership rules, income earned through the death of an S corporation shareholder is includible, to a pro rata extent, on the deceased shareholder's final return.⁶³ Third, partnerships cannot have undistributed earnings and profits from prior tax years, whereas S corporations which once were "regular" (C) corporations can.⁶⁴ This additional distinction in the treatment of partnerships and S corporations further suggests a difference in how IRD rules could be applied (or not applied) in each context. Fourth, an election to have the basis of assets of the S corporation changed to reflect a change in the basis of the shares when they are transferred is not provided, although such an election is provided for partnership assets when there has been a transfer of a partnership interest.⁶⁵ Fifth, partnership items of income, gain, loss, deduction, and credit may be allocated by any method agreed to by the partners, provided that the allocation has substantial economic effect.⁶⁶ In contrast, allocations of income, loss, deduction, and credit for S corporations are on a per share/per day basis.⁶⁷ Sixth, no gain or loss is recognized to a partnership upon the distribution of property by the partnership to a partner.⁶⁸ In contrast, gain is recognized to an S corporation upon the distribution of property by the S corporation to a shareholder.⁶⁹ Finally, it should be noted that a corporation may change from a "regular" corporation to an S corporation and back to a regular corporation, subject to certain time restrictions.⁷⁰ If the S corporation's status is terminated, then application of the IRD rules would not seem possible, except as to unpaid dividends where the shareholder has died after the record date.⁷¹ Indeed, having the corporation terminate S corporation status

63. I.R.C. § 1366(a)(1). At the time Rev. Rul. 64-308 was promulgated, the rules for partnerships and S corporations in this regard were substantially the same; the successor reported the income for the whole year. Yet, the ruling concludes that there was no IRD with the corporation ever, Rev. Rul. 64-308, 1964-2 C.B. 176, although the Service later ruled that income earned in the partnership through the partner's death was IRD. Rev. Rul. 68-215, 1968-1 C.B. 312.

64. See I.R.C. § 1371.

65. I.R.C. §§ 743, 754. It was the application of these sections which was the specific focus of the courts in *Quick Trust* and *Woodhall*. See *supra* notes 43-48.

66. I.R.C. § 704(b).

67. I.R.C. §§ 1366(b), 1377(a).

68. I.R.C. § 731(b).

69. I.R.C. § 1363(d).

70. I.R.C. § 1362(g) (generally, if S corporation status terminates, corporation cannot regain S corporation status for five years).

71. IRD is included in the gross income of the person who collects it and who acquired the right to it from the decedent. I.R.C. § 691. If the corporation is no longer an S corporation when the income is received, it will be taxed to the corporation and not to the new shareholder. An effect similar to treating the item as IRD might be achieved in such a case by denying the

shortly before the shareholder's death would seem to preclude any part of the corporation's income earned after the shareholder's death from being treated as IRD.⁷² The fact that this result could be achieved so simply suggests that Rev. Rul. 64-308 continues to apply. Thus, there can be no income in respect of a deceased shareholder of an S corporation.⁷³

The decision in *Rollert Residuary Trust v. Commissioner*⁷⁴ suggests that the court would be reluctant to allow taxpayers to "defeat the overall scheme of section 691" through the use of an S corporation.⁷⁵ In *Rollert*, the taxpayer attempted to avoid the section 1014(c) denial of a "step-up" in basis for IRD by obtaining a change in basis under Treasury Regulation section 1.661(a)-2(f).⁷⁶ That Treasury Regulation provides that no gain is realized by an estate or trust upon distribution of appreciated property to a residuary legatee. The beneficiary's basis in the property distributed is, in effect, the amount the beneficiary must include in income on account of its distribution.⁷⁷ In *Rollert*, the decedent's estate assigned its right to receive bonuses payable in subsequent years.⁷⁸ The estate treated the assignment as a distribution of income under section 661 in the year of the assignment. The beneficiary, in turn, included the value of the right in his gross income under section 662 and, in effect, claimed a basis equal to this income under the Treasury Regulation.⁷⁹

shareholder basis in the stock—clearly a "forced" result and not one suggested by the Code itself. See I. GRANT, SUBCHAPTER S TAXATION § 530.1 (2d ed. 1988).

72. See *Boyle v. United States*, 355 F.2d 233 (3d Cir. 1965) (no IRD even where decedent was sole shareholder of a corporation entitled to a dividend arrearage from another corporation).

73. The same result seems to occur even if S corporation status ends after the shareholder's death but only for the entire year of the corporation in which the shareholder's death occurs.

74. 80 T.C. 619 (1983), *aff'd*, 752 F.2d 1128 (6th Cir. 1985).

75. *Id.* at 647.

76. *Id.* at 647-48 ("petitioner's interpretation of section 1.661(a)-2(f), Income Tax Regs., sees [the Commissioner] as having allowed by regulation what was specifically denied by statute under section 1014(c), i.e., a step-up basis to the date-of-death value for rights to income in respect of a decedent").

77. Treas. Reg. § 1.661(a)-2(f) (as amended in 1973).

78. *Rollert*, 80 T.C. at 625-26. The decedent, Rollert, was an executive vice-president of General Motors. He had been awarded lifetime bonuses which were payable in annual installments, most of which remained unpaid at his death. GM also determined an additional bonus for the decedent which was not formally awarded until approximately three months after his death. The rights to these payments were part of the decedent's residuary estate under the terms of his will. The estate distributed the right to these future payments to the residuary legatee. *Id.* at 620-27.

79. *Id.* at 638-39. Under sections 661 and 662, an estate or trust which distributes property to a beneficiary is treated, subject to certain exceptions, as distributing its specially computed

Upon payment of the bonus, the beneficiary only included in income the excess of the amount received over the amount previously included in the income.⁸⁰ The court noted that the taxpayer's treatment of the bonus substantially reduced the aggregate income reported by the estate and the taxpayer. The taxpayer benefited because the estate was able to reduce its income and accumulate funds which could subsequently be paid out tax-free to the taxpayer.⁸¹

The court concluded that to allow the basis increase to the taxpayer would undermine the purpose of section 691. Therefore, the court held that section 691 overrides the general distribution rules of sections 661 and 662 and that the taxpayer does not receive a basis in the bonus equal to the fair market value at the date of distribution of those bonus rights.⁸²

Reliance on *Rollert* to solve the issue of the application of IRD to S corporations begs the question. In *Rollert*, it was conceded that the payment was IRD.⁸³ In Rev. Rul. 64-308 the issue was whether the item was IRD. The Service ruled that there is no IRD in the S corporation context. Moreover, at the time of the ruling, the possibility of a taxpayer "defeat[ing] the overall scheme of section 691" if present at all, was just as present as when the *Rollert* decision was issued. The ruling's impact actually can be more adverse to a taxpayer than if the income of the S corporation had been treated as IRD.⁸⁴ Hence, *Rollert* should not be construed as resolving the issue of how IRD may arise in the context of an S corporation.

III. TAX CONSEQUENCES OF NOT TREATING S CORPORATION STOCK AS IRD

If the portion of the value of S corporation stock attributable to IRD-type items (e.g., accounts receivable) in the corporation were treated as IRD then the following tax consequences would arise. First, the stock would receive only a partial change in basis in the successor's hands because the change in basis would not be allowed

taxable income ("distributable net income") for which the estate or trust receives a deduction and which is included in the beneficiary's gross income. I.R.C. §§ 661-662 (1982). I.R.C. § 643(a) defines "distributable net income."

80. *Rollert*, 80 T.C. at 639.

81. *Id.* at 643.

82. *Id.* at 642, 648. Distributions of property carry out distributable net income only to the extent of the lesser of the property's basis or fair market value. I.R.C. § 643(e).

83. *Rollert*, 80 T.C. at 635 ("payments under the post mortem bonus award were income in respect of a decedent when received by the estate of the petitioner").

84. *See supra* note 19.

for the S corporation's IRD-type items.⁸⁵ The successor shareholder would be taxed on his or her share of the IRD-type items as those items are collected by the S corporation.⁸⁶

If the portion of the value of the stock attributable to IRD-type items were not treated as IRD, the successor still would be required to include in income his or her share of the IRD-type items when they were collected under the general rules of section 1366. However, the basis of the stock in the hands of the successor would equal the estate tax value of the shares: fair market value at the date of the decedent's death.⁸⁷ Thus, the basis as determined would be available to allow the successor to deduct S corporation items of loss or deduction in subsequent years.⁸⁸ Moreover, the basis could give rise to a deductible capital loss if the corporation were liquidated following the collection of the IRD-type items.⁸⁹ This loss could, in turn, be used to offset the capital gain or part of the ordinary income arising from the collection of the IRD-type items.

The consequences of not treating stock in an S corporation as IRD are illustrated by the following example. Sam Stock sells a parcel of real estate with a value of \$1 million and adjusted basis of \$100,000 on the installment method of section 453, receiving a note for \$1 million. He subsequently transfers the note to an S corporation. The note is the S corporation's only asset.

Generally, no gain or loss is recognized upon the transfer of property to a controlled corporation under section 351.⁹⁰ Thus, provided that a business purpose exists for the transfer, the transfer of the note to the corporation would be tax free since "property" includes an installment obligation held by the transferor.⁹¹

85. I.R.C. § 1014(c).

86. I.R.C. § 1366.

87. I.R.C. § 1014(a).

88. I.R.C. § 1366(d).

89. The loss would not qualify as an ordinary loss under I.R.C. § 1244 because ordinary loss treatment is allowed only to the person to whom the stock was issued. Treas. Reg. § 1.1244(a)-1(b) (as amended in 1981).

90. See I.R.C. § 368(c) (defining control as ownership of 80% or more of the corporation's stock). However, the transfer must have a business purpose to qualify as a tax-free exchange under I.R.C. § 351.

91. Treas. Reg. § 1.453-9(c)(2) (as amended in 1976); see *Meagher v. Commissioner*, 20 B.T.A. 68 (1930) (transfer of uncollected installment obligations which represented unrealized profits did not give rise to gain or loss to sole proprietor who organized a corporation to which he transferred all of the assets of the business, including the uncollected installment obligations, in exchange for all of the corporation's authorized stock); cf. *Hempt Bros. v. United States*, 490 F.2d 1172 (3d Cir.) (incorporation of partnership, in which all of the partnership's accounts receivable and inventory were transferred to the corporation in exchange for stock, resulted in income to the corporation from the collection of the accounts and also resulted in

Any amounts received by the S corporation in payment of the installment note would be treated in the same manner as those amounts would have been treated if received by the transferor. Thus, a pro rata share of each payment would be included in the shareholder's gross income as capital gain and interest income.

Further, assume that upon the sole shareholder's death, the stock passes to his wife. On the first day of the S corporation's succeeding taxable year, the surviving spouse causes the corporation to sell the installment note for \$1 million.⁹² Thereafter, the S corporation is liquidated and its assets (cash of \$1 million) are distributed to the surviving spouse.

The sale of the installment note by the S corporation would be treated as a disposition of the note under section 453B. Accordingly, all of the \$900,000 deferred gain would be recognized in the year of receipt. The surviving spouse would be required to include in gross income her pro rata share of the corporation's income.⁹³ In this case, she would include the entire \$900,000 of gain since she is the only shareholder. The surviving spouse's basis in her S corporation stock would be computed as follows: \$1 million pursuant to section 1014(a) plus \$900,000 pursuant to section 1367(a)(1)(A). On liquidation of the S corporation, no gain would be recognized by the corporation because it is distributing cash.⁹⁴ The surviving spouse, however, would recognize a \$900,000 loss under sections 331 and 1001 on the liquidation: \$1.9 million basis in the stock less the \$1 million distribution. The \$900,000 loss would offset the \$900,000 gain on the sale of the installment note. Hence, neither the decedent nor the surviving spouse would be taxed on the \$900,000 gain.

CONCLUSION

Unless a portion of a deceased shareholder's stock in an S corporation is treated as IRD (where the S corporation holds assets which would be IRD if held by a partner or directly by the decedent), taxpayers may be able to avoid a section 1014(c) denial of step-up in

the inventory having a basis of zero, rather than its fair market value, in the hands of the corporation), *cert. denied*, 419 U.S. 826 (1974).

92. If the sale occurs in the year of the deceased shareholder's death, then a pro rata share of the gain would be allocated to him. I.R.C. § 1366(a)(1). This appears to provide an opportunity for "accelerating" at least a portion of the income onto the decedent's final return. This acceleration would appear to be a total one if the corporation can and does "split" the corporation's year under I.R.C. § 1362(e).

93. I.R.C. §§ 453B, 691(a)(4).

94. I.R.C. § 1371(e).

basis by holding installment notes in S corporations or by operating a business through an S corporation. If the business is operated as an S corporation, then accounts receivable of the S corporation could receive the benefit of an indirect step-up in basis by reason of the step-up in basis in the stock. Although the legislative history of the Subchapter S Revision Act of 1982 suggests that Congress intended to treat S corporations in a manner somewhat similar to partnerships, it is unclear that Rev. Rul. 64-308 has been overruled. Indeed, the failure to enact specific provisions dealing with IRD in the S corporation context, similar to those dealing with partnerships, suggests that the conclusion of the ruling remains in effect. This means that no IRD arises with respect to a deceased shareholder's interest in an S corporation except for dividends unpaid at death where the shareholder has died before the record date.

