The Consequences of the Subchapter S Revision Act for Oil and Gas Investors

Laurie Anne Patterson

Follow this and additional works at: http://digitalcommons.law.utulsa.edu/trl

Part of the Law Commons

Recommended Citation
Laurie A. Patterson, The Consequences of the Subchapter S Revision Act for Oil and Gas Investors, 19 Tulsa L. J. 406 (2013).

Available at: http://digitalcommons.law.utulsa.edu/trl/vol19/iss3/4

This Casenote/Comment is brought to you for free and open access by TU Law Digital Commons. It has been accepted for inclusion in Tulsa Law Review by an authorized editor of TU Law Digital Commons. For more information, please contact daniel-bell@utulsa.edu.
THE CONSEQUENCES OF THE
SUBCHAPTER S REVISION ACT
FOR OIL AND GAS INVESTORS

I. INTRODUCTION

The subchapter S corporation was established in the tax law in 1958 to give businesses an alternative form of operation and, consequently, an alternative to being taxed as a corporation, a partnership or a sole proprietorship. Since its inception, however, subchapter S has not been widely used by the oil and gas industry because of the severe tax disadvantages of operating in the subchapter S form. The primary disadvantage was the effect of the percentage depletion deduction on the earnings and profits calculation of the subchapter S corporation and, consequently, on the taxability of distributions to its shareholders. The entire system of taxing distributions by the subchapter S corporation was a complex maze which trapped many shareholder-taxpayers. In addition, the subchapter S corporation was undesirable because of severe restrictions on deductions for losses.

The Subchapter S Revision Act of 1982 (Revision Act) was intended to eliminate the traps and to produce a simpler, more rational taxing scheme. For the oil and gas industry, the Revision Act eliminates the percentage depletion problem and treats the S corporation and its shareholders more like a partnership and its partners.

---

2. See MILLER'S OIL & GAS FEDERAL INCOME TAXATION 498 (J. Houghton 20th ed. 1982); Rowen, Structuring an Oil and Gas Drilling Fund for Individuals, 35 TAX. LAW. 577, 577 (1982); Morley & Ross, Percentage Depletion and the Subchapter S Election, 23 OIL & GAS TAX Q. 197, 197 (1975).
3. See infra text accompanying notes 137-51.
8. Id.; for a discussion of percentage depletion see infra notes 137-60 and accompanying text.
This Comment will first review the prior rules governing Subchapter S treatment of income, earnings and profits, distributions, and basis, while concurrently addressing the changes to these items effected by the Revision Act. This background material is included for those readers heretofore unfamiliar with the Subchapter S form and its trappings. Second, it will examine the changes made by the Revision Act which are important to the oil and gas industry, including changes in the percentage depletion rules and windfall profits tax rules. Third, it will examine other major changes made by the Revision Act, which have a significant impact on the attractiveness of the S corporation to the oil and gas industry, including changes in the loss limitation rules and the eligibility, election, and termination rules. Finally, the S corporation will be compared to the partnership form to determine whether the changes will induce the oil and gas industry to operate in the S form.

II. OVERVIEW OF SUBCHAPTER S

A. The Subchapter S Corporation

Congress enacted the subchapter S provisions to permit businesses to select a form of organization without basing that selection primarily on tax consequences. The Subchapter S provisions have successfully provided businesses with another option in formation, but the provisions have been unsuccessful in eliminating tax consequences as a primary consideration.

Since a corporation generally is considered an entity separate and apart from its shareholders, it is taxed as a separate entity. A corporation is taxed on its income, retains its losses, and gets its own specific deductions. Once taxed, the corporation may distribute its

---

10. See Kantor, To Elect or Not to Elect Subchapter S—That is a Question, 60 TAXES 882, 882 (1982); Miller, A Walking Tour Through S-Land, 10 J. REAL. EST. TAX’N 235, 242 (1983).
13. Id. § 11(a).
14. Id. § 172.
15. Id. §§ 241-248.
profits in money or property to its shareholders and that distribution is income to the shareholders, that is, the corporate profits are taxed again in the hands of its shareholders. 16 A partnership, on the other hand, generally is not considered a separate entity by the law 17 and consequently is not taxed as one. Partnership income is not taxed at the partnership level, 18 instead, the income, whether distributed or not, passes through to the partners who pay taxes on it. 19 The character of any losses, deductions, or credits, and the character of any income is reflected in each partner's personal income. 20 Partnership distributions to partners are generally without tax consequences. 21

The subchapter S corporation is a hybrid between a corporation and a partnership. 22 While the subchapter S corporation adopts much of the corporate form, unlike a non-electing corporation, 23 it does not pay taxes on its income nor does it retain its losses. 24 Instead, like a partnership, each shareholder declares his pro rata share of the corporation's income and deducts its losses. 25 However, unlike a partnership, a subchapter S corporation, operating under the 1958 rules, was unable to preserve the character of the items passed through to shareholders, with the exception of capital gains income and net operating losses. 26 Finally, distributions to shareholders by subchapter S corporations generally were not tax free. 27

B. Income

Prior to the Subchapter S Revision Act, corporations that elected subchapter S status were not taxed on their income, with the exception of certain capital gains. 28 Instead, shareholders were to include in their

16. See id. § 301(c).
17. See UNIF. PARTNERSHIP ACT § 6(1), 6 U.L.A. 22 (1969). "A partnership is an association of two or more persons to carry on as co-owners a business for profit." Id.
19. Id. §§ 61(a)(3), 701-703.
20. Id. §§ 61, 702(b).
21. Id. § 731.
22. Although the subchapter S provisions often were described as "a method of taxing corporations as if they were partnerships," the partnership provisions differed significantly. S. REP. No. 640, 97th Cong., 2d Sess. 5, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3257.
23. References in this Comment to "non-electing corporations" are referring to traditional, non-S corporations. The Revision Act designates non-S corporations as "C corporations." I.R.C. § 1361(a)(2) (1982).
24. Id. §§ 1372(b), 1374 (1976) (repealed 1982); id. §§ 1363(a), 1366 (1982).
25. Id. §§ 1373, 1374 (1976) (repealed 1982); id. § 1366 (1982).
26. See id. §§ 1373, 1374(a), 1375(a) (1976) (repealed 1982).
27. See id. § 1373.
income any amounts actually distributed to them by the corporation and their share of the corporation's undistributed taxable income. Only shareholders who remained shareholders on the last day of the corporation's taxable year were required to include the undistributed taxable income in their own gross income. Each shareholder's portion of the undistributed taxable income was the proportionate amount which he would have received as a dividend had the corporation distributed all of its undistributed taxable income.

The corporation's undistributed taxable income was its taxable income, less the amount of current earnings and profits actually distributed and taxed to shareholders as a dividend. The subchapter S corporation computed its taxable income like any other non-electing corporation except that it did not reflect any deductions for net operating losses or for dividends received in its computation.

In addition to the subchapter S corporation's undistributed taxable income, only two items passed through directly to its shareholders. The gains tax was imposed on certain subchapter S corporations and was designed to prevent existing corporations from electing subchapter S treatment for one year only to pass through large amounts of capital gains income to their shareholders without being taxed at the corporate level as well as at the shareholder level. The corporation also is subject to the alternative minimum tax on tax preference items.

The corporation also is subject to the alternative minimum tax on tax preference items. The corporation's undistributed taxable income was its taxable income, less the amount of current earnings and profits actually distributed and taxed to shareholders as a dividend. The subchapter S corporation computed its taxable income like any other non-electing corporation except that it did not reflect any deductions for net operating losses or for dividends received in its computation.

In addition to the subchapter S corporation's undistributed taxable income, only two items passed through directly to its shareholders. The gains tax was imposed on certain subchapter S corporations and was designed to prevent existing corporations from electing subchapter S treatment for one year only to pass through large amounts of capital gains income to their shareholders without being taxed at the corporate level as well as at the shareholder level. I.R.C. § 1378 (1976) (repealed 1982); Treas. Reg. § 1.1378-1, -2 (1968); see S. REP. No. 640, 97th Cong., 2d Sess. 14, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3265. This tax on the corporation is retained by the Revision Act. See I.R.C. § 1374 (1982).


29. See infra notes 76-90 and accompanying text.
31. Id § 1373(b); Treas. Reg. § 1.1373-1(a)(1), T.D. 7564, 1978-2 C.B. 19, 19. This provision allowed shareholders in high income tax brackets to shift recognition of the subchapter S corporation's undistributed income to a lower-bracket taxpayer at the last minute. See Miller, supra note 10, at 246. This provision with its potential for abuse has been changed by the Revision Act. See infra note 56 and accompanying text.
33. Id § 1373(c). The taxable income amount also was reduced by the amount of taxes imposed directly on the corporation under the capital gains provision and the minimum tax provision. Id.; see supra note 28.
34. A net operating loss is simply the excess of deductions allowed to an entity over its gross income. I.R.C. § 172(c) (1982).
35. Corporations generally are able to deduct from their gross income 85% of dividends they receive from other corporations. Id. § 243(a)(1) (1982).
36. Id § 1373(d) (1976) (repealed 1982); see Shaw & August, supra note 28, at 84. The corporation did not include net operating losses because the losses were passed through directly to the shareholders who deducted them. See I.R.C. § 1374 (1976) (repealed 1982). If both the corporation and the shareholders were allowed to deduct them, a double deduction would result.
first was the net operating loss deduction. Unlike the allocation of undistributed taxable income to shareholders, the net operating loss was allocated on a daily basis to each of the shareholders in proportion to the number of shares they held on that day. Thus, even if a shareholder did not own any shares in the corporation at the end of its taxable year, and consequently did not report any undistributed taxable income, the shareholder nevertheless was able to claim a deduction for losses during the year. Strict limits were imposed, however, on the amount of net operating losses a shareholder could deduct. The second item specifically passed through was net capital gains. Shareholders were able to treat as long term capital gains amounts actually or constructively distributed out of the corporation's earnings and profits, to the extent of the shareholder's pro rata share of capital gain for the year. The net capital gains, like net operating losses, were allocated to shareholders whether they held stock at the end of the taxable year or not. On the sale or exchange of an asset, the characterization of the gain as ordinary income or capital gain was determined by the character of the asset in the hands of the corporation, unless a shareholder owning a substantial portion of the corporation's stock used the corporation to sell off his personal assets. In that case the character of the gain was determined by its character in the hands of the shareholder.

The Revision Act retained the basic model of subchapter S. The S corporation generally is not subject to taxes on its income, with the exception of certain capital gains. The Act adds a new tax, however, on excess passive investment income of certain corporations.

38. Id. § 1374(c)(1). The amount allocated each day was determined by dividing the corporation's net operating loss for the taxable year by the number of days in the year. Id.
39. See infra text accompanying notes 276-81.
41. Id. § 1375(a)(1) (1976) (repealed 1982). Amounts constructively distributed were amounts taxed to the shareholders as undistributed taxable income. See Treas. Reg. § 1.1375-1(a), T.D. 7728, 1978-2 C.B. 19, 19. The amount of the corporation's net capital gain could not exceed the corporation's taxable income. I.R.C. § 1375(a)(1) (1976) (repealed 1982). The shareholder's pro rata share of the corporation's net capital gain was the amount which bore the same ratio to that gain as the amount of actual and constructive dividends reported by the shareholder bore to the entire amount of actual and constructive dividends reported by all shareholders. Id. § 1375(b).
43. Id. § 1.1375-1(a).
44. Id.
46. I.R.C. § 1375(a) (1982). The tax replaces the prior rule which caused a corporation's
The S corporation's taxable income is included in the gross income of its shareholders. However, instead of only net operating losses and capital gains, many more items are passed through directly to the shareholders. Any item of income including tax-exempt income, losses, deductions, or credits, which could affect the tax liability of shareholders if treated separately, must be set out and passed through individually. In addition, the character of each item is passed through. For example, when the S corporation makes a charitable contribution, the corporation will not deduct the contribution from the income it passes through and the corporate limit on charitable contributions no longer will apply. Instead, each shareholder will be able to deduct his portion of the contribution from his own income subject to his individual limits on deductibility. Any remaining items of income, loss, deduction, or credit which would not individually affect the tax liability of any shareholder are lumped together and passed through as "nonseparately computed income or loss." The taxable income of an S corporation generally is computed like that of a partnership, that is, both compute their income like an individual. The deductions not allowed to a partnership similarly are not allowed to the S corporation.

Each shareholder's share of tax items is now allocated to shareholders on a "per-share, per-day" basis rather than allocating all undistributed income to only those who are shareholders at the end of the year. The amount of loss each shareholder can deduct is limited as under prior law, but the limitations are less severe. In summary, subchapter S status to terminate if it had too much passive investment income. Id. § 1372(e)(5) (1976) (repealed 1982); see infra text accompanying notes 292-313.

48. Id. § 1366(a)(1)(A).
49. Id. § 1366(b).
53. I.R.C. §§ 703(a), 1363(b) (1982).
54. Id. §§ 703(a)(2), 1363(b)(2).
55. S. Rep. No. 640, 97th Cong., 2d Sess. 17, reprinted in 1982 U.S. CODE CONG. & AD. News at 3268. The "per-share, per-day" allocation is determined by assigning an equal portion of each tax item to each day of the taxable year and then by dividing that portion pro rata among all shares outstanding on that day. I.R.C. § 1377(a)(1) (1982).
56. This eliminates the potential for abuse available to those in a high tax bracket who would shift stock ownership at the end of the year to persons in lower tax brackets to avoid inclusion of large amounts of undistributed taxable income. See supra note 31.
57. See infra notes 276-81 and accompanying text.
58. See I.R.C. § 1366(d) (1982); see infra notes 282-91 and accompanying text.
under the new rules the S corporation is a conduit similar to a partnership.  

C. Earnings and Profits

Subchapter S corporations, like all non-electing corporations, were required to maintain an earnings and profits account. Generally, the earnings and profits account of a corporation is computed by adding to its taxable income all items of income considered tax-exempt, which include interest on tax-exempt bonds and certain items which were deducted in computing taxable income such as depreciation in excess of straight line depreciation. Then certain items not deductible in computing taxable income are deducted, such as federal income taxes paid, expenses incurred in earning tax-exempt income, and dividend distributions to shareholders. The earnings and profits are divided into two accounts. One is a current earnings and profits account based on income, expenses, and distributions in the current year. The second is an accumulated earnings and profits account based on income, expenses, and distributions for all prior years of the corporation. The earnings and profits accounts of a corporation are used to determine whether that corporation's distribution of money or property to its shareholders is treated as a dividend taxable to the shareholder, a tax-free return of capital, or a gain on the sale or exchange of property.

Earnings and profits of subchapter S corporations generally were computed like those of non-electing corporations, however, several special rules applied. The amount of the subchapter S corporation's undistributed taxable income for a taxable year which was included in the gross income of its shareholders under section 1373(b) was de-

61. See Treas. Reg. § 1.312-6(b) (1955).
62. Id. § 1.312-6(c); for a general discussion of earnings and profits computation see B. BITTKER & J. EUSTICE, supra note 60, at ¶ 7.03.
63. See Treas. Reg. § 1.312-6(a) (1955).
64. I.R.C. §§ 301(c), 316 (1982). Distributions of non-electing corporations are deemed to come first from current earnings and profits and then from accumulated earnings and profits. Treas. Reg. § 1.316-2(a) (1955). Such distributions are taxable as dividends and included in the shareholder's ordinary income. I.R.C. § 301(c)(1) (1982). Only after the earnings and profits accounts are exhausted are distributions deemed to be a tax-free return of capital which reduces the shareholder's basis in his stock and then deemed to be a gain from the sale or exchange of property. See Treas. Reg. § 1.301-1(f) example 1, T.D. 7587, 1979-1 C.B. 126.
ducted from the corporation’s earnings and profits account at the end of that year. Later distributions of undistributed taxable income or of previously taxed undistributed income did not reduce earnings and profits; earnings and profits also were not affected by net operating losses. As with non-electing corporations, the earnings and profits account of the subchapter S corporation was used to determine the taxability of actual and constructive distributions by the corporation to its shareholders.

The Subchapter S Revision Act eliminated the earnings and profits accounts for new corporations electing subchapter S status. No post-1982 earnings of any S corporation, new or old, will be considered earnings and profits. However, the accumulated earnings and profits accounts will be carried over for S corporations which have earnings and profits from years in which they were non-electing corporations, or for years before 1983 in which they were subchapter S corporations. The accumulated earnings and profits account carried over by the S corporation helps determine the taxability of distributions by the S corporation. The account can be reduced only by the amount of distributions deemed to come from the accumulated earnings and profits.

The S corporation with accumulated earnings and profits also must establish a new accumulated adjustments account. An accumulated adjustments account reflects the amount of the corporation’s accumulated post-1982 gross income, less deductible expenses, which has not been distributed. The accumulated adjustments account also affects the taxability of distributions by the corporation.

---

66. I.R.C. § 1377(a) (1976) (repealed 1982). Undistributed taxable income was deducted from the subchapter S corporation’s earnings and profits because it had already been taxed as a dividend to shareholders. Id. § 1373(b). Any distributions out of undistributed taxable income therefore were not taxed a second time.

67. Id. §§ 1375(d)(1), (f)(1), 1377(d). Both distributions are encompassed within the reduction of earnings and profits for undistributed taxable income included within the gross income of shareholders.

68. Id. § 1377(c). That is because net operating losses were deducted directly by shareholders, id. § 1374, and served to reduce paid in capital of the corporation; see Treas. Reg. § 1.1377-2(a)(2) example 1 (1959).

69. See infra notes 76-90 and accompanying text.


71. Id. An S corporation also could have earnings and profits carried over from a corporate acquisition. Id.

72. See I.R.C. § 1368(c)(2) (1982); see infra notes 96-101 and accompanying text.

73. I.R.C. § 1371(c)(3) (1982); see infra notes 96-99 and accompanying text.


75. Id. § 1368(e)(1)(A); S. REP. No. 640, 97th Cong., 2d Sess. 20, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3271.
D. Distributions

Under prior law, distributions by the subchapter S corporation were taxed to shareholders in a complex system based on both subchapter S rules and the rules governing non-electing corporations.\textsuperscript{76} The prior subchapter S rules depended heavily on the corporate tax concepts of dividends\textsuperscript{77} and earnings and profits, combined with the unique subchapter S concepts of undistributed taxable income and previously taxed undistributed income. Previously taxed undistributed income was defined as the undistributed taxable income for all prior taxable years of the electing corporation.\textsuperscript{78}

As a general rule, if the subchapter S corporation distributed amounts out of either undistributed taxable income or out of previously taxed undistributed income, the distribution was tax free to the shareholder.\textsuperscript{79} If the amounts were distributed out of either current or accumulated earnings and profits, they were taxable as dividends.\textsuperscript{80} However, a priority system determined when a distribution was from earnings and profits and when it was from undistributed income.\textsuperscript{81} In addition, the treatment of distributions of property differed from the treatment of distributions of money.

Essentially, a subchapter S corporation could make a tax-free cash distribution after the first two and one half months of its taxable year only if the amount of the distribution exceeded earnings and profits for the year.\textsuperscript{82} A distribution within the first two and a half months of a subchapter S corporation's taxable year could be tax free to a shareholder only if that shareholder held his stock on the last day of the

\textsuperscript{76} Distributions by non-electing corporations, other than distributions in redemption or liquidation, are governed by sections 301, 311 and 312, found in subchapter C of title 1 of the Internal Revenue Code. I.R.C. §§ 301, 311, 312 (1982).

\textsuperscript{77} Dividends are specifically defined as any distribution of property by a corporation to its shareholders out of current or accumulated earnings and profits. \textit{Id.} § 316(a).

\textsuperscript{78} \textit{Id.} § 1375(d)(1) (1976) (repealed 1982).


\textsuperscript{81} In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income . . . ; (4) a dividend to the extent of accumulated earnings and profits . . . ; (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.


previous taxable year. Any shareholder's right to distributions out of undistributed taxable income or previously taxed undistributed income was personal and could not be transferred, that is, only shareholders who had paid the taxes on the undistributed amount could receive the distributions tax free. Consequently, both the shareholders and the corporation had to keep records concerning the shareholder's shares of undistributed taxable income and previously taxed undistributed income. Distributions of property other than money could not be distributions of either undistributed taxable income or previously taxed undistributed income, and so almost always were taxable as dividends.

Because money and property were treated differently, characterization of an item as either money or property was important. "Money" is defined in the regulations as not including corporate obligations or property other than money. A distribution of a corporation's notes and debentures, or of its checks drawn on bank accounts with insufficient funds was held to be a distribution of property, not money. Moreover, the courts generally were willing to look to the substance of a distribution to see whether cash or property actually was distributed.

The Revision Act has greatly simplified the distribution rules, although some problems remain. No distinction is made between distributions of property and distributions of money. If the S corporation has no accumulated earnings and profits carried over from previous years, the rules are very straightforward. A distribution is tax free to a shareholder to the extent of his adjusted basis in the corporation's

87. S. Rep. No. 640, 97th Cong., 2d Sess. 19, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3270. "Property distributions [had] the following tax consequences under [prior] law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock." Id.
90. See De Treville, 445 F.2d at 1308 (court found a distribution of cash to shareholders followed by shareholders' purchase of electing corporation's stock in insurance company for price equal to cash distribution was a distribution of property).
91. See I.R.C. § 1368(a) (1982).
stock. Any amount distributed in excess of his adjusted basis is treated as gain from the sale or exchange of property, generally, it will be capital gain. The treatment of a shareholder under these rules parallels the treatment of a partner who receives a distribution from a partnership.

The rules are more complicated for S corporations with carried over accumulated earnings and profits, although they are less complex than the old distribution rules. A distribution by an S corporation with accumulated earnings and profits is tax free to the shareholder to the extent of the corporation’s accumulated adjustments account. If the distribution from the accumulated adjustments account exceeds a shareholder’s basis in his stock, it is taxed as gain from the sale or exchange of property. Whether a distribution is in excess of the accumulated adjustments account and whether the amount the shareholder received is in excess of his stock basis is determined after adjustments are made to the account and to the shareholder’s basis at the end of the taxable year. If the distribution is in excess of the accumulated adjustments account, it is treated as a dividend out of the accumulated earnings and profits of the corporation to the extent of the carried over account.

The purpose of the accumulated adjustments account is to assure shareholders of tax free treatment on distributions, to the extent of the corporation’s post-1983 earnings, regardless of when the distributions are made. The new rules make the S corporation more attractive since the old rules taxed as dividends the most recent earnings. The Revision Act provides an election for an S corporation to avoid a possi-

---

92. Id. § 1368(b)(1). “Basis” of an asset generally is defined as the cost of that asset. Id. § 1012. Adjusted basis is the original cost amount increased or decreased for various reasons such as additional costs charged to the asset or deductions taken on the asset. Id. §§ 1011, 1016. For example, the original basis of a piece of equipment used in business is its cost. As the business depreciates the equipment for tax purposes, its basis is reduced by the amount of the depreciation deduction. Stock basis and the adjustments to it are discussed infra notes 112-35 and accompanying text.


96. Id. § 1368(c)(1).

97. Id.

98. Id. § 1368(d).

99. Id. § 1368(c)(2). Amounts distributed in excess of accumulated earnings and profits are treated as though the S corporation had no accumulated earnings and profits. Id. § 1368(c)(3).

ble trap created by the carried over accumulated earnings and profits account, since a distribution may be characterized as dividend income. The corporation can elect to treat its distributions as coming first from the carried over accumulated earnings and profits and then from the accumulated adjustments account.\textsuperscript{101}

While a distribution of property is taxed no differently to the shareholder than a distribution of money, a distribution of appreciated property will cause other tax consequences. A distribution of appreciated property to a shareholder in his capacity as a shareholder is treated as a sale and causes the S corporation to recognize gain as though the property were sold at its fair market value.\textsuperscript{102} The amount of the distribution to the shareholder is also the fair market value of the property.\textsuperscript{103} While gain must be recognized,\textsuperscript{104} the rules apparently do not allow for the recognition of losses if the corporation distributes property with a fair market value of less than its adjusted basis.\textsuperscript{105} The gain is ordinary income or capital gain, depending on the character of the property in the hands of the corporation.\textsuperscript{106} The sale treatment could cause recapture of depreciation, as well as recapture of intangible drilling and development cost deductions previously taken.\textsuperscript{107} That gain and any recapture is passed through to the shareholders as income.\textsuperscript{108}

This treatment of distributions of appreciated property does not match the treatment given partnerships. A partnership recognizes no gain on the distribution of appreciated property to a partner.\textsuperscript{109} The

\begin{itemize}
\item\textsuperscript{101} I.R.C. § 1368 (e)(3)(A) (1982).
\item\textsuperscript{102} Id. § 1363(d).
\item\textsuperscript{103} S. REP. No. 640, 97th Cong., 2d Sess. 20, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3271.
\item\textsuperscript{104} The amount of the corporation's gain is the fair market value of the property less its adjusted basis in the hands of the corporation. I.R.C. § 1001(a) (1982).
\item\textsuperscript{105} See id. § 1363(d).
\item\textsuperscript{106} Id. § 1366(b).
\item\textsuperscript{107} See id. §§ 1245, 1254. The principle behind the recapture provision is that since the depreciation and intangible drilling and development cost deductions taken on an asset have reduced ordinary income, the amount by which the ordinary income has been reduced will be recovered when the asset is sold. Therefore even if the asset is a capital asset, the taxpayer must recognize ordinary income to the extent of the deductions previously taken. See id.
\item\textsuperscript{108} See id. § 1366(a)(1). The corporation must recognize gain on the distribution to prevent a "cheap" step up in basis to the shareholder. The basis the shareholder takes in the property is its fair market value basis, not the basis to the corporation. Id. § 301(d)(1). If no gain was recognized by the corporation, the corporation could distribute assets tax free to the shareholder. The shareholder then could sell the assets without recognizing any gain since his basis, the fair market value, would be the same as the amount he would receive on a sale. See S. REP. No. 640, 97th Cong., 2d Sess. 20, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3271.
\item\textsuperscript{109} I.R.C. § 731(b) (1982).
\end{itemize}
partner who receives the property instead takes the basis the partner
ship had in the property and recognizes gain only when he sells the
property. 110 The partnership and its partners, therefore, are able to
depreciation of the gain in appreciated property, unlike the S corpo-
ration and its shareholders. The S corporation gain recognition
requirement also could trigger the tax on capital gains if the property is
a capital asset and if the corporation is not new or has not had a sub-
chapter S election in effect for the last three years. 111 As a result, the
appreciated property rule could become a trap for the unwary.

E. Basis

A shareholder in a subchapter S corporation has a basis both in his
stock in the corporation and in any indebtedness of the corporation to
him. Both the stock basis and the debt basis are affected by earnings,
losses, and distributions by the subchapter S corporation, 112 and both
in turn affect other items.

Under prior law, a shareholder’s basis in his stock was increased
by the amount of undistributed taxable income he was required to in-
clude in his gross income, 113 and was decreased by the amount of the
corporation’s net operating loss which the shareholder deducted. 114
Distributions out of undistributed taxable income and previously taxed
undistributed income and distributions in excess of accumulated earn-
ings and profits also reduced the shareholder’s stock basis. 115 The
amount of distributions from undistributed taxable income and previously taxed undistributed income considered tax-free was limited by
the stockholder’s stock basis. 116 Additional amounts were taxed as a
gain on the sale or exchange of property. 117

A shareholder’s debt basis 118 was reduced by the amount of the

110. Id. § 732(a)(1).
111. Id. § 1374(a), (c).
112. Id. § 1367; id. § 1376 (1976) (repealed 1982).
113. Id. § 1376(a) (1976) (repealed 1982). The effect of the rule was the same as if the corpo-
ration had distributed the undistributed taxable income amount as a dividend on the last day of its
taxable year and the shareholder then had reinvested that amount. Treas. Reg. § 1.1376-1 (1959).
§ 1.1375-6(a)(1) (1968).
117. Id.
118. It is not clear exactly what is considered a corporate debt to the shareholder. A guaranty
by the shareholder of a corporate debt to a third party is not considered a corporate debt to the
shareholder. See Perry v. Commissioner, 47 T.C. 159, 164 (1966). The Internal Revenue Service
has ruled that a corporate debt to the shareholder exists where a shareholder executes his own
The corporation's net operating losses he deducted which exceeded his basis in his stock. However, the prior rules provided no means for increasing the shareholder's basis in his indebtedness.

The stock and debt basis together limited the amount of net operating loss the shareholder could deduct. The deductible amount could not exceed the adjusted basis of the shareholder's stock and the adjusted basis of any indebtedness of the corporation to the shareholder.

The Subchapter S Revision Act provides a means to restore a shareholder's debt basis once it has been reduced by the amount of deduction, losses, and distributions allocated to him which exceed his basis. If the shareholder's debt basis has been reduced, any items of income allocated to the shareholder will be used first to restore the debt basis and then to increase his stock basis.

The new ability to restore debt basis is important. Under prior law, shareholders whose debt basis had been reduced could be surprised to find they had large amounts of taxable gain when the corporation repaid them. The amount of the gain was the amount by which the repayment exceeded the shareholder's reduced debt basis. The restoration rule therefore minimizes the amount of gain the shareholder must recognize on repayment of the debt.

The Revision Act also has broadened the list of items which affect the shareholder's stock basis. Both taxable income and tax-exempt income charged to the shareholder will increase his basis. Losses and both deductible and nondeductible expenses charged to the shareholder will decrease his stock basis. The shareholder's stock basis

---

120. See id. § 1376(a), (b)(2); Treas. Reg. § 1.1376-2(b) (1959).
121. I.R.C. § 1374(c)(2) (1976) (repealed 1982); see infra notes 276-91 and accompanying text (discussion of the implications of the deductible loss limits).
124. See Cornelius v. Commissioner, 494 F.2d 465, 470 (5th Cir. 1974).
also is reduced by the amount of tax free distributions to him. These rules are similar to the rules governing adjustment of a partner's basis in his partnership interest.

One major difference remains, however, between the partnership and S corporation basis rules. Debt of the S corporation to third parties does not increase the basis of the shareholder, while debt of the partnership to third parties does increase the partner's basis. The difference in treatment is important because basis affects both the amount of net operating losses which can be deducted, and the amount of cash and property which the S corporation can distribute tax free to its shareholders. Since distributions to both shareholders and partners are tax free to the extent of their basis, the partner has an advantage. His basis, and thus the distributions he can receive tax free, will be greater because he was allowed to increase it by his share of partnership debt.

In summary, the shareholder's basis in stock and debt puts a ceiling on the amount of S corporation losses and deductions the shareholder can claim. In addition, the stock basis limits the amount of distributions the shareholder can receive tax free.

III. SUBCHAPTER S TREATMENT OF OIL AND GAS PRODUCTION

A. Percentage Depletion

The Subchapter S Revision Act has changed entirely the treatment of the percentage depletion deduction by S corporations and their shareholders. The new rules are very similar to the percentage depletion rules governing partnerships. The changes are in line with the

---

129. Id. §§ 705(a), 733.
130. See id. § 1367(a)(1).
131. See id. §§ 705, 722, 752; Treas. Reg. § 1.752-1(a) (1956). The rationale for the difference may be that under state law a shareholder, unlike a general partner, is generally considered to have limited liability for corporate debts. However, that rationale is inapplicable where the shareholder has personally guaranteed the debt of the corporation, or where the partnership has non-recourse debt. Yet a guaranty by the shareholder is not sufficient to increase his basis. See Perry, 47 T.C. at 164.
132. See infra notes 284-91 and accompanying text.
134. Id. § 1366(d)(1); see infra notes 284-91 and accompanying text.
135. See I.R.C. § 1368(b)(1) (1982). Of course, a second limit for S corporations with carried over accumulated earnings and profits is the amount of the accumulated adjustments account. Id. § 1368(d)(1); see supra notes 96-100 and accompanying text.
new rules governing the pass through of income and deductions, distributions, and basis. In addition, the changes affect the percentage depletion "proven property rule" as applied to S corporations.

1. The Percentage Depletion Deduction and Its Effect on Distributions

Under prior law, the subchapter S corporation first had to compute its depletion\(^{137}\) deduction in order to determine its taxable income.\(^{138}\) The depletion deduction was not passed through to the shareholders directly.\(^{139}\) The subchapter S corporation computed the amount of cost depletion\(^ {140}\) and the amount of percentage depletion\(^ {141}\)

\(^{137}\) Depletion for oil and gas is defined as "exhaustion of oil and gas reserves by the drilling of wells and the resultant production therefrom. In the field of federal income taxation, it is a deduction from gross income provided by the Code to compensate for the taxpayer's capital diminution brought about by production." MILLER'S OIL AND GAS FEDERAL INCOME TAXATION 1 (J. Houghton 21st ed. 1983) [hereinafter cited as MILLER'S]. The depletion deduction is similar to the deduction for depreciation allowed on property used in trade or business. The business property depreciation deduction compensates for the "exhaustion, wear and tear" on the property as it is used in business. I.R.C. § 167(a) (1982). The depletion deduction similarly is allowed to compensate for the capital assets consumed in mineral production, that is, the oil and gas taken from the property which cannot be replaced. See Anderson v. Helvering, 310 U.S. 404, 408 (1940).


\(^{139}\) The depletion deduction is allowed for the holder of an economic interest in property. Palmer v. Bender, 287 U.S. 551, 557 (1933). An economic interest is defined as an interest in minerals in place, acquired by investment and secured by a legal relationship, such that the interest owner can look only to the minerals in place as source for the return of his investment. Treas. Reg. § 1.611-1(b)(1), T.D. 7261, 1973-1 C.B. 309, 319.

\(^{140}\) Cost depletion is calculated on each oil or gas property separately. See id. § 1.613-1, T.D. 7170, 1972-1 C.B. 178, 179. A "property" is defined as "each separate property owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." I.R.C. § 614(a) (1982).

\(^{141}\) Percentage depletion is not tied to the taxpayer's basis or cost. Instead, a deduction is allowed based on a specified percentage of the gross income from the property. I.R.C. §§ 613(a), 613A(c)(1) (1982). Thus, percentage depletion deductions may be claimed in amounts greater than the taxpayer's basis or investment in the property. In 1975, the percentage depletion deduction was repealed for oil and gas production with certain limited exceptions. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 89 Stat. 26, 47 (1975); I.R.C. §§ 613(d), 613A(a) (1982). The primary exception was for independent producers and royalty owners who were allowed to take percentage depletion on so much of their average daily production of crude oil or natural gas as did not exceed their allowable depletable oil and natural gas quantity. I.R.C. § 613A(c)(1) (1982).
to which it was entitled, and deducted the greater amount, as required.\textsuperscript{142}

The difficulty under prior law arose when the percentage depletion amount provided the larger deduction. The problem was that while percentage depletion had to be used to calculate the subchapter S corporation's taxable income, cost depletion, the lower figure, had to be used to compute the corporation's earnings and profits.\textsuperscript{143} Treasury Regulation section 1.312-6(c)(1) states that "percentage depletion under all revenue acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation."\textsuperscript{144} When cost depletion was less than percentage depletion, the corporation's current earnings and profits account could be greater than its taxable income since a smaller amount would be subtracted

An independent producer basically is any taxpayer other than a retailer or a refiner. \textit{Id.} § 613A(d)(2), (4). A retailer is any taxpayer who directly or through a related person sells more than five million dollars worth of oil, gas, or related products under contract to a retailer or someone who leases space or uses a trade name of the taxpayer or through a retail outlet. \textit{Id.} § 613A(d)(2). A refiner is any taxpayer who directly or through a related person refines more than 50,000 barrels on any day. \textit{Id.} § 613A(d)(4).

The independent producer's depletable quantity currently is 1,000 barrels, reduced by the amount of the taxpayer's secondary or tertiary production. \textit{Id.} § 613A(c)(3). The taxpayer may apportion his depletable quantity between oil production and natural gas production in any manner he chooses; one barrel of oil is equivalent to 6,000 cubic feet of natural gas. \textit{Id.} § 613A(c)(3), (4).

The depletion deduction cannot exceed 50\% of the taxable income from the property, figured without the depletion allowance. \textit{Id.} § 613(a); Treas. Reg. § 1.613-1, T.D. 7170, 1972-1 C.B. 178, 179. In addition, the percentage depletion deduction cannot exceed 65\% of the taxpayer's taxable income for the year calculated without regard to depletion, net operating losses and several other items. I.R.C. § 613A(d)(1) (1982).

Cost depletion can be calculated any time a lease bonus or advance royalty is received on a property even though no production has occurred. Treas. Reg. § 1.612-3(a)(1), (b)(1), T.D. 7523, 1978-1 C.B. 192, 192. It is disputed whether percentage depletion may be claimed on the lease bonus or advance royalty amounts. The Internal Revenue Service, Tax Court and Court of Claims have agreed that taxpayers may not claim a percentage depletion deduction on lease bonus or advance royalty amounts when no production occurs. Rev. Rul. 81-44, 1981-1 C.B. 384; Farmar v. United States, 689 F.2d 1017, 1025 (Ct. Cl. 1982) (lease bonus not subject to percentage depletion), \textit{cert. granted}, — U.S. —, 103 S. Ct. 722 (1983); Engle v. Commissioner, 76 T.C. 915, 927 (1981) (advance royalty not subject to percentage depletion), \textit{rev'd}, 677 F.2d 594 (7th Cir. 1982), \textit{cert. granted}, — U.S. —, 103 S. Ct. 722 (1983); Glass v. Commissioner, 76 T.C. 949, 959 (1981) (lease bonus not subject to depletion). The Seventh Circuit Court of Appeals has disagreed, holding that taxpayers are entitled to percentage depletion on advance royalties even though no production has occurred. Engle v. Commissioner, 677 F.2d 594, 602 (7th Cir. 1982), \textit{cert. granted}, — U.S. —, 103 S. Ct. 722 (1983). The Supreme Court has agreed to review the Farmar and Engle cases. — U.S. —, 103 S. Ct. 722 (1983).\textsuperscript{145}

\textsuperscript{142}. I.R.C. § 613(a) (1982).


\textsuperscript{144}. Treas. Reg. § 1.312-6(c)(1) (1955).
from income in the earnings and profits calculation than in the taxable income calculation. When the current earnings and profits account exceeded taxable income, amounts actually distributed to shareholders in excess of taxable income constituted taxable dividends to the shareholders rather than a tax free return of capital or previously taxed income. In addition, over the years the excess in earnings and profits could build up in the accumulated earnings and profits account so that almost any distribution would be taxed as an ordinary dividend.

Moreover, this result was endorsed by both case law and the Treasury Regulations. One subchapter S corporation shareholder argued that the earnings and profits percentage depletion rule was not applicable to subchapter S corporations. The shareholder argued that subchapter S corporations should be treated as proprietorships or partnerships instead. A federal district court, however, rejected that argument and upheld the regulations requiring the earnings and profits of the subchapter S corporation to be computed in the same manner as for non-electing corporations. The Treasury Regulations use the percentage depletion problem to illustrate the operation of the prior distribution rules.

The percentage depletion problem has been blamed for oil and gas industry reluctance to use the subchapter S corporation. Because the Subchapter S Revision Act has eliminated the percentage depletion problem for new corporations electing S status, the oil and gas industry now may be more willing to operate in the S form.

The S corporation no longer is allowed a depletion deduction.

145. The computation of earning and profits is described supra notes 60-69 and accompanying text.
146. See supra note 81 and accompanying text.
149. Id. at 377. The section held valid was Treas. Reg. § 1.1377-2(b) (1959).
150. Treasury Regulation § 1.1373-1(g) provides the following example: An electing small business corporation has $70,000 of taxable income and $100,000 of earnings and profits for its taxable year, and distributes $80,000 during that year to its shareholders. The difference between taxable income and current earnings and profits of $100,000 is attributable to the fact that certain deductions allowable in computing taxable income (such as percentage depletion in excess of cost depletion) do not decrease earnings and profits. The distributions of $80,000 during the taxable year are still included as dividends in the gross income of the shareholder since they are distributions out of earnings and profits. Treas. Reg. § 1.1373-1(g) example 2, T.D. 7564, 1978-2 C.B. 19, 19.
151. See Massoglia & Choate, supra note 147, at 102; Kanter, supra note 10, at 918; Morley & Ross, supra note 2, at 197.
Instead, the shareholders individually are entitled to the depletion deduction on their pro rata share of the oil and gas production of the corporation. Each shareholder is treated as having produced his pro rata share. The treatment essentially is the same as for partners in an oil and gas partnership: shareholders directly receive the benefit of the percentage depletion deduction. In addition, no earnings and profits account is maintained for any post-1982 S corporation earnings. Consequently, the percentage depletion problem is eliminated by the new rules. At least one commentator expects that this change will stimulate increased use of the S corporation by the oil and gas industry.

For oil and gas corporations electing S status after 1982, however, existing accumulated earnings and profits will be carried over, and thus the percentage depletion problem is carried over as well. The carryover results because the difference between percentage depletion and cost depletion is held in the accumulated earnings and profits account which must be maintained. Any distributions in excess of the corporation’s current year earnings and its accumulated adjustments account will be considered to come from the accumulated earnings and profits and will be taxable as ordinary dividend income. To avoid the possibility of dividend income surfacing in the future, the S corporation may, with the consent of all its shareholders, elect to have distributions come from the accumulated earnings and profits first. In that way, the deemed dividend distributions can be planned for and thus will not surprise shareholders.

2. Oil and Gas Property Basis and Distributions of Appreciated Property

Under prior law, the subchapter S corporation held oil or gas property and adjusted its basis in the property to reflect depletion and

---

153. Id.; S. REP. No. 640, 97th Cong., 2d Sess. 24, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3274. This treatment is in line with the new income and deduction pass through rules. Since the percentage depletion rules impose a ceiling on the deduction of 65% of the taxpayer’s taxable income, I.R.C. § 613A(d)(1) (1982), the deduction is one which could affect the tax liability of any shareholder if treated separately. See id. § 1366(a)(1)(A).


156. See Kanter, supra note 10, at 918.

157. See I.R.C. §§ 1366(c); 1371(c) (1982).

158. Id. § 1366(c)(2).

159. Id. § 1368(c)(3).
other deductions. Under the Revision Act, each shareholder is allocated his share of the adjusted basis of the S corporation in each oil and gas property held by the corporation. The basis allocation is made in the first taxable year of the S corporation to which the Revision Act applies, or on the date the property is acquired by the S corporation, whichever is later. Each shareholder is required to adjust his allocated basis in all mineral properties for any depletion deduction he takes, to keep records of his adjusted basis for each property, and to use his adjusted basis to compute his cost depletion or the gain or loss he incurs on the disposition of any of the properties. In this respect the S corporation and its shareholders are treated the same as partnerships and their partners. The basis allocation is considered more equitable since some shareholders or partners may be able to use percentage depletion while others are precluded from using it, at least in part, because of the 65 percent income limit or the one thousand barrel per day depletible oil quantity. If the basis was adjusted at the partnership or S corporation level, deductions for percentage depletion by some partners or shareholders would more quickly reduce the basis of the property and jeopardize the cost depletion deduction for those unable to use percentage depletion.

The S corporation's record-keeping requirements have not been completely removed. The basis of the property to the S corporation for determining gain or loss on its disposition or on its distribution to the shareholders is equal to the sum of the adjusted basis of each of the shareholders. The S corporation must, therefore, maintain records of the adjusted basis of each shareholder in each oil and gas property.
property.\textsuperscript{167} If the S corporation does distribute an oil and gas property to its shareholders, the amount of the distribution is the fair market value of the property.\textsuperscript{168} If the corporation has no accumulated earnings and profits, the distribution is a tax free return of capital to the extent of the shareholder's basis in his stock and the excess is taxed as a gain from the sale or exchange of property.\textsuperscript{169} If the S corporation has carryover accumulated earnings and profits, the distribution could be taxed as a dividend to the shareholders, to the extent the value of the property exceeds the accumulated adjustments account.\textsuperscript{170} In addition, the corporation must recognize gain on the distribution as though the property were sold, if the fair market value is greater than the adjusted basis of the property.\textsuperscript{171} The amount of the gain, usually capital in nature, plus any recapture\textsuperscript{172} is passed through to the shareholders to be included in their income.\textsuperscript{173}

As indicated above, the requirement that the S corporation recognize gain on a distribution and pass it through to its shareholders puts the S corporation at a disadvantage compared to the partnership which recognizes no gain on the distribution of appreciated property to a part-

\textsuperscript{167} Shareholders, like partners, probably will have to report their individual adjusted basis figures to the S corporation. Massoglia & Choate, supra note 147, at 102.

\textsuperscript{168} See S. REP. No. 640, 97th Cong., 2d Sess. 20, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3271; I.R.C. § 301(b)(1)(A) (1982). This discussion ignores for the moment the percentage depletion proven property transfer rule. Under the rule, it is possible that by distributing its oil and gas properties, an S corporation may preclude use of the percentage depletion allowance by its shareholders with respect to the distributed properties. See infra notes 180-210 and accompanying text.

\textsuperscript{169} I.R.C. § 1368(b) (1982); see supra notes 92-95 and accompanying text.

\textsuperscript{170} I.R.C. § 1368(d)(2) (1982); see supra notes 96-99 and accompanying text.

\textsuperscript{171} I.R.C. § 1363(d) (1982); see supra notes 102-08 and accompanying text. The amount of the gain is the excess of the fair market value over the adjusted basis of the property in the hands of the corporation. I.R.C. §§ 1363(d), 1001(a) (1982). The adjusted basis of the oil and gas property is the sum of its adjusted bases in the hands of each shareholder.

\textsuperscript{172} See supra notes 107-08 and accompanying text. The character of the gain is based on the character of the property in the hands of the corporation. I.R.C. §§ 1363(d), 1366(b) (1982). The possibility of recapture is to recover deductions previously taken. Oil and gas properties are subject to recapture of intangible drilling cost deductions previously taken. See id. § 1254. The amount required to be recaptured is taxed at ordinary income rates rather than at the lower capital gains rates. Id. § 1254(a).

\textsuperscript{173} I.R.C. § 1366(a) (1982).

Under the old rules, if the S corporation had substantial earnings and profits, the shareholders would have recognized dividend income to the extent of the value of the property. Treas. Reg. § 1.1375-4(b), T.D. 6960, 1968-2 C.B. 342, 353. In addition, the corporation would have to recognize recapture of any intangible drilling cost deductions previously taken, which also would have been passed on as income to the shareholders. I.R.C. § 1254(a) (1982); id. § 1373 (1976) (repealed 1982). Consequently the shareholders would have recognized income greater than the value of the distributed property. See Massoglia & Choate, supra note 147, at 103.
Moreover, the gain recognition rule could create a trap for the S corporation by triggering a capital gain tax.  

3. Adjustments to the Shareholder's Stock Basis

Depletion deductions affect the S corporation shareholder's basis in his stock as well as his basis in his pro rata share of the corporation's oil and gas properties. The amount of the shareholder's depletion deduction reduces his basis in the stock. His stock basis is increased by the amount by which the depletion deduction exceeds the basis of the property subject to depletion. The result is that the shareholder's stock basis is reduced only by an amount which totals his basis in the oil and gas property allocated to him. The same rules govern adjustment of the basis of a partner in his partnership interest.  

B. Percentage Depletion and the Proven Property Transfer Rule

In 1975 Congress eliminated the percentage depletion deduction for the oil and gas industry, exempting only independent producers and royalty owners, along with certain other limited exceptions. Congress also attempted to insure that the number of exemptions would not proliferate by adopting rules which deny percentage depletion deductions on proven oil and gas properties transferred after 1974. A property is a proven oil or gas property if at the time it is transferred its principal value has been "proven" by prospecting, exploration, or discovery work. A transfer is deemed to occur on the day the contract took effect.
or commitment to transfer becomes binding or the day on which ownership actually passes if there is no binding contract. A proven property is deemed transferred and ineligible for percentage depletion if there is a change in the legal or equitable ownership of the property by "sale, exchange, gift, lease, sublease, assignment, contract, or other disposition." Any contribution of property to a corporation or a partnership and any distribution by a corporation or a partnership is a transfer. Moreover, any change in the membership of a partnership or any increase in a taxpayer's proportionate share of the production income subject to depletion is a transfer.

One specific exception to the transfer rule allows individuals to transfer qualified oil and gas property to a qualified corporation solely in exchange for stock in that corporation. Although the Code section does not specifically say so, legislative history indicates the exception will apply only if the transfer to the corporation qualifies as a nontaxable exchange under section 351. Qualified property is property which has not previously been transferred and thus still qualifies for percentage depletion. A qualified corporation is one which has issued all of its outstanding stock for qualified property. If the requirements are satisfied an individual can transfer oil and gas properties without losing percentage depletion, but the individual and the corporation must share a single one thousand barrel depletable oil quantity. The statute provides a method for allocating the property, minus actual expenses of the transferee for equipment and intangible drilling and development costs, at the time of the first production from the property subsequent to the transfer and before the transferee himself transfers his interest.


184. Id.
185. Id.
186. Id.
187. I.R.C. § 613A(c)(10) (1982). Other specific exceptions include transfers at death and transfers between corporations which are members of a controlled group of corporations, between business entities under common control, or between related persons in a family. Id. § 613A(c)(9)(D)(i), (iv), (v).
189. I.R.C. § 613A(c)(10)(E)(i) (1982). The individual transferring the property must elect to have the transfer exception apply. Id. § 613A(c)(10)(E)(ii). In addition to the mineral interest, a maximum of $1,000 in cash and production equipment necessary for the property and in place at the time of the transfer also may be included. Id. § 613A(c)(10)(E).
190. Id. § 613A(c)(10)(D).
191. Id. § 613A(c)(10)(C).
192. Allocation is a method used by the proven property rules to allow limited transfers of proven property. See, e.g., id. § 613A(c)(9)(B)(iv), (v). Businesses under common control and
ration’s depletable oil quantity between the corporation and the taxpayer. The “qualified property, qualified corporation” exception was formerly the only way to transfer proven oil and gas properties to a subchapter S corporation.

An election by a corporation to become a subchapter S corporation was not considered a transfer which barred percentage depletion. However, a transfer of oil and gas property from the subchapter S corporation to one of its shareholders did end the percentage depletion allowance.

The Subchapter S Revision Act has virtually reversed the transfer rules for S corporations. Under the new transfer rules the S corporation is treated as a partnership and its shareholders as partners. An election by a corporation to become an S corporation is treated as a transfer of all its properties effective the day the election is made and terminates the percentage depletion allowance. In addition, if an S corporation decides to become a non-electing corporation, each shareholder is treated as having transferred to the corporation his pro rata share of all assets of the S corporation. Apparently, the termination of election and the asset transfer will have to meet the requirements of the qualified property, qualified corporation exception.

The new S corporation transfer rules are consistent with the changes made by the Revision Act in the computation of the depletion deduction and the role of the shareholders in the S corporation. The depletion deduction is computed separately by each shareholder and members of the same family are either treated as one taxpayer or required to allocate a single depletable quantity among themselves. See id. § 613A(c)(8).

193. The transferor’s depletable quantity is reduced by his pro rata share of the corporation’s depletable oil quantity. His pro rata share is the amount of the corporation’s depletable oil quantity allocable to the production from the proven properties and his proportionate share, based on stock ownership, of all other production of the corporation. See id. § 613A(c)(10)(C)(ii); see S. Rep. No. 1039, 96th Cong., 2d Sess. 22, reprinted in 1980 U.S. CODE CONG. & AD. NEWS at 7253-54.

194. See Kanter, supra note 10, at 919.

195. Rev. Rul. 80-43, 1980-1 C.B. 133, 134. The ruling reasoned that when a corporation elected subchapter S status, there was no transfer of legal or equitable ownership of the corporation’s property. See id. The corporation owned the same oil and gas properties after the election. See supra at 3273; Massoglia & Choate, supra note 147, at 103.


198. Id. § 613A(c)(13)(C)(ii).  

199. Id. § 613A(c)(13)(D).

200. See id. § 613A(c)(10).
each has his own depletable oil quantity.201 If the old transfer rules had been retained, a corporation could have acquired and proved an oil and gas property and then elected S corporation status. Before electing S status, only the corporation would have been entitled to a percentage depletion allowance on the property. After electing S status, the new depletion deduction rules would entitle each shareholder to the percentage depletion allowance, making the exemption more available than intended.

Since the partnership transfer rules apply to the S corporation and its shareholders, some guidance is available about the kinds of transactions that will not cause the depletion deduction to be lost. For example, if two partners each transfer a proven property to the partnership, the amount of the percentage depletion allowance to which each is entitled depends on the allocation of income between the partners. If the partnership agreement provides that each partner will take the gross income from the property he transferred, then each is entitled to a full percentage depletion allowance since each was entitled to a full percentage depletion allowance on the property immediately before the transfer.202 If, however, no special allocation had been made, but each partner shared equally in all income from both properties, each partner would be entitled to a depletion allowance based on only one-half of the production from the property he had contributed.203 Shareholders in an S corporation, unlike partners, cannot make special allocations of income or deductions. Therefore, if an S corporation had two shareholders, each would be entitled to share equally in all income from both properties.204 Thus, each shareholder would be entitled to a depletion allowance based on only one-half of the production from the property he had contributed.

Oil and gas partnerships and certain carried interest arrangements205 appear to have a distinct advantage over S corporations because of their flexibility in allocating production without losing the percentage depletion allowance. For example, in a carried interest ar-

---

201. Id. § 613A(c)(13)(A).
203. Id.
205. A carried interest arrangement exists where one party, known as the carrying party, owns a portion of the working interest in an oil and gas property and agrees to pay the entire cost of drilling, developing, operating, and equipping the well. In return he gets all production from the well until he has recouped all costs of drilling, developing, and equipping it, plus all costs of operating it, that is, until all the carrying party’s costs have been recouped. Miller’s, supra note 137, at 250.
rangement, the carrying party is considered to own the entire working interest until he has recovered all of his costs of drilling, equipping and operating the well. A fraction of the ownership interest would then revert to the carried party. Percentage depletion is not lost when the fractional interest reverts to the carried party because a reversion is not considered a transfer. Similarly, where one party subleases an oil property to another and retains a royalty with the right to convert the royalty to a working interest, the percentage depletion allowance is not lost when the option is exercised because the conversion is not a transfer. Shareholders in an S corporation, unlike parties in a carried interest arrangement, are limited to receiving production in proportion to their ownership interests. If one shareholder seeks to increase his ownership interest in the S corporation after a property is proven, he will not be entitled to a percentage depletion allowance on the increase in the share of production he receives. The portion of the depletion allowance attributable to that share will be considered lost. In short, even after the Subchapter S Revision Act the flexibility available to partnerships and to carried interest arrangements may make those forms of business more attractive to the oil and gas industry than the S corporation form.

C. Windfall Profit Tax

The Subchapter S Revision Act has changed the application of the windfall profit tax as it is applied to S corporations and their shareholders. The new law treats the S corporation and its shareholders like a partnership and its partners. The Crude Oil Windfall Profit Tax of 1980 was imposed as part of a phased decontrol of crude oil prices. The tax is imposed on producers of crude oil, with certain exceptions for independent producers and royalty owners and for the differing

---

207. Id. example 6.
210. See id. Notice, however, that the partnership agreement, like the carried interest arrangement, can be drafted to allocate a higher percentage of the production to one partner initially and then allocate production evenly between partners after a certain point without loss of the depletion deduction. See id. example 11. The depletion deduction is not lost because the agreement that the share of one partner decrease and the shares of the others increase is made before the property is proven, and is similar to the reversion. Id.; see id. example 5.
212. Oosterhuis, The Crude Oil Windfall Profit Tax Act of 1980, 39 INST. ON FED. TAX’N ¶ 42.01, ¶ 42.02(2) (1981).
grades and sources of oil produced. The tax basically is a percentage of
the "windfall profit" earned on each barrel of oil produced. 213 The
windfall profit is the difference between the sale price of the oil at the
well, with certain adjustments, and the price that would have been paid
had price controls continued in effect. 214 The specific tax rate percent-
age is determined by the kind of oil produced and whether the pro-
ducer is qualified as an independent producer.

Oil is divided into three tiers. Tier-three oil is newly discovered
oil, heavy oil, and incremental oil 215 and is taxed at a thirty percent rate
for all producers, except for newly discovered oil which is taxed at
lower rates. 216 Tier-two oil consists of oil from stripper wells which is
not tier-three oil, 217 and production from a national petroleum reserve
held by the federal government. 218 It is taxed at a sixty percent rate
generally, and a thirty percent rate for independent producer oil. 219
Since January 1, 1983, however, stripped-well oil produced by inde-
pendent producers is exempt from the tax. 220 Tier-one oil is all other
domestically produced oil not included in tiers two or three. 221 Tier-
one oil is taxed at a seventy percent rate generally and a fifty percent
rate for independent producer oil. 222

A producer is any owner of an economic interest in crude oil. 223 In
a partnership the partners are considered to be the producers. 224 In-
dependent producer oil must be produced from a working or operating
interest. 225 An independent producer may claim the exemption for one
thousand barrels of oil a day 226 and must own the working interest
from which the oil is produced. 227 Generally, a person who qualifies as
an independent producer for the percentage depletion deduction excep-

---

214. Id. § 4988(a); Oosterhuis, supra note 212, at ¶ 42.02[3].
215. I.R.C. § 4991(e)(1) (1982). Heavy oil, incremental oil, and newly discovered oil are defined by the Code. Id. §§ 499(e)(2), (3), 4993.
216. Id. § 4987(b)(3)(A). The tax on newly discovered oil is gradually being reduced to 15% by 1986. Id. § 4987(b)(3)(B).
217. Id. § 4991(d)(1)(A).
218. Id. § 4991(d)(1)(B).
219. Id. § 4987(b)(1), (2).
220. Id. § 4991(b).
221. Id. § 4991(c).
222. Id. § 4987(b)(1), (2).
223. Id. § 4992(a)(1)(A).
224. Id. § 4992(a)(1)(C).
225. Id. §§ 4992(d)(1)(D), 614(d). Royalty interests, net profits interests, and other interests which do not bear part of the operating expenses are excluded. Id. § 4992(d)(2).
226. Id. § 4992(c).
227. Id. § 4992(d)(1)(D).
tion also qualifies as an independent producer for the windfall profit tax.\(^{228}\) Groups of related taxpayers must share the one thousand barrel per day independent producer oil amount.\(^{229}\) For the purposes of windfall profit taxes and percentage depletion, a "related group" is similarly defined, although there are some differences.\(^{230}\)

The windfall profit tax statutes also have a proven property transfer rule which is similar to the percentage depletion transfer rule. No taxpayer can claim independent producer status for an interest in property transferred after December 31, 1979.\(^{231}\) However, if the taxpayer acquired an interest in property which has been owned at all times since that date by persons who were independent producers claiming no more than one thousand barrels of production per day, the taxpayer could still qualify for independent producer status.\(^{232}\)

An exemption from the tax has been added for royalty owners who are individuals, estates, or qualified family farm corporations.\(^{233}\) The exemption is available only for "qualified royalty production," defined as oil production attributable to an interest other than a working interest.\(^{234}\) The royalty exemption currently is two barrels per day of qualified production.\(^{235}\) After 1984 the exemption amount will increase to three barrels per day.\(^{236}\)

For the producers and the oil subject to the tax, a ceiling has been placed on the amount which can be considered windfall profit. The windfall profit on a barrel of oil cannot be greater than ninety percent of the net income for that barrel.\(^{237}\) The net income per barrel is determined by dividing taxable income from the property by the number of barrels of oil produced from it. To determine taxable income, adjustments must be made for depletion deductions, intangible drilling cost deductions, the windfall profit tax, and certain other items.\(^{238}\)

\(^{228}\) Id. § 4992(b); see supra note 141.


\(^{230}\) Id. §§ 4992(e)(2), 613A(o)(8).

\(^{231}\) Id. § 4992(d)(3); see supra notes 180-186 and accompanying text.


\(^{233}\) Id. §§ 4991(b)(5), 4994(f), 6429(d)(1).

\(^{234}\) Id. § 6429(d)(2). The definition also excludes certain overriding royalties, production payments, net profits interests, and similar interests. Id.

\(^{235}\) Id. § 4988(b)(1).

\(^{236}\) Id. § 4988(b)(3).
nearnships, the net income limit is determined separately for each partner.\textsuperscript{239}

Before the Revision Act the S corporation was treated as the producer and the windfall profit tax was imposed directly on the corporation.\textsuperscript{240} Thus the one thousand barrel per day independent producer exemption applied to the corporation, not its shareholders. In addition, a transfer of property from or to the subchapter S corporation violated the independent producer transfer rule, resulting in a higher tax rate, unless specifically exempted.\textsuperscript{241} Finally, the subchapter S corporation did not qualify for the royalty owner exemption since it was a corporation.\textsuperscript{242}

For purposes of the windfall profit tax, the Revision Act treats the S corporation like a partnership,\textsuperscript{243} and its shareholders like partners. The S corporation is not considered the producer.\textsuperscript{244} Instead, the crude oil produced by the S corporation is allocated to each shareholder in proportion to his share of the corporation’s income.\textsuperscript{245} Each shareholder is treated as the producer of the crude oil allocated to him.\textsuperscript{246} A new provision aimed specifically at the independent producer rules states that the S corporation and its shareholders shall be treated as a partnership and its partners.\textsuperscript{247} Thus, like partners, each shareholder who qualifies as an independent producer will qualify for his own one thousand barrel exemption.\textsuperscript{248} The independent producer transfer rules governing partnerships also will apply. The new rule is no different than the old transfer rule, however, since any transfer to or by a partnership is a disqualifying transfer\textsuperscript{249} unless the exceptions apply. It is also likely that the percentage depletion rule making an election or termination of S status a transfer will be applied.\textsuperscript{250} Finally, it is likely that the royalty owner exemption will apply for shareholders of S corporations receiving royalty income, since the individual shareholders, not the corporation, are the producers.

\textsuperscript{239} Treas. Reg. § 51.4988-2(c)(3) (1980).

\textsuperscript{240} S. REP. No. 640, 97th Cong., 2d Sess. 23, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3274.

\textsuperscript{241} See id.


\textsuperscript{243} S. REP. No. 640, 97th Cong., 2d Sess. 23, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3274.

\textsuperscript{244} See I.R.C. § 4996(a)(1)(C) (1982).

\textsuperscript{245} Id. § 4996(a)(1)(C)(ii).

\textsuperscript{246} Id. § 4996(a)(1)(C)(ii).

\textsuperscript{247} Id. § 4992(f).

\textsuperscript{248} See id. § 4992(a).

\textsuperscript{249} See Temporary Treas. Reg. § 150.4996-3(b) (1980).

For certain S corporations, however, an election is available to have the old subchapter S rules apply. The election is available to S corporations which were S corporations on September 28, 1982, and which were qualified oil and gas production corporations. A qualified corporation is one which, with any of its substantial shareholders, averaged daily production of more than one thousand barrels of oil or gas. A substantial shareholder is defined as any person who owns more than forty percent of the stock of the corporation. If the election is made, the S corporation still will be the producer for purposes of both the percentage depletion deduction and the windfall profits tax. In cases where the corporation and the shareholder combined have more than one thousand barrels of production a day but individually have less than one thousand barrels a day the election may be beneficial. The following example is an illustration:

If a shareholder's allocable share of crude oil was 400 barrels per day from a Subchapter S corporation whose production of crude oil was 800 barrels per day and the shareholder had an additional 700 barrels per day from other sources, he would be subject to the windfall profit tax since his total average daily production was 1,100 barrels. Under prior law, he would not have been subject to this tax.

The same illustration is applicable to the one thousand barrel percentage depletion deduction. However, if the election is made, the prior subchapter S rules governing income and distributions will apply, causing the earnings and profits problem.

D. Tax Preference Items

An added tax generally is imposed on taxpayers in addition to their regular income tax when they have large amounts of tax preference items. Tax preference items are certain tax items which serve to reduce substantially a taxpayer's income, such as the capital gains deduction or accelerated depreciation deductions on real property, leased personal property, or leased recovery property. Two items of tax preference are particularly important for the oil and gas industry. One is the amount by which “excess intangible drilling costs” exceed the

252. Id. § 6(c)(3)(B).
253. Id. § 6(c)(3)(D).
256. Id. § 57(a).
taxpayer’s net income from all oil and gas properties.257 An excess intangible drilling cost is the excess of the intangible drilling cost deduction taken over the deduction which would have been allowed if intangible drilling expenses had been capitalized and deducted over a ten-year period.258 The other significant oil and gas tax preference item is the excess of the percentage depletion deduction taken on a property over the adjusted basis of that property.259

The alternative minimum tax on taxpayers other than corporations is equal to the excess of twenty percent of the taxpayer’s alternative minimum taxable income over his regular tax for the taxable year.260 The alternative taxable income is basically the taxable income computed without the tax preference items.261 The minimum tax on corporations is equal to fifteen percent of the excess of tax preference items over the greater of $10,000 or the regular tax imposed, reduced by allowable credits.262

Before the Revision Act, the subchapter S corporation computed its tax preference items, including oil and gas preference items, and allocated them proportionately among its shareholders.263 For example, the corporation would calculate the excess percentage depletion available to it and pass that through to the shareholders. It also would calculate the intangible drilling cost preference amount. To calculate that amount, however, the corporation used only net income from interests in oil and gas properties held by the corporation.264

Under the new law the shareholders each compute the amount of tax preference items separately. The computation of excess percentage depletion is done by each shareholder based on his own depletion deduction and his own adjusted basis in the property.265 Similarly, each shareholder computes his own intangible drilling cost preference amount using his share of the net income from the S corporation oil and gas properties and his net income from all of his own oil and gas properties.266 The difference to the shareholder can be significant when

257. Id. § 57(a)(11)(A).
258. Id. § 57(a)(11)(B).
259. Id. § 57(a)(8).
260. Id. § 55(a).
261. Id. § 55(b).
262. Id. § 56(a), (c).
263. Id. § 58(d).
264. See Massoglia & Choate, supra note 147, at 104.
265. Id. This is in line with the allocation of production to each shareholder and the allocation of basis in the property to each shareholder. See I.R.C. § 613A(o)(13)(A), (B) (1982).
266. This also is in line with the separate pass-through to shareholders of items of income,
the shareholder's total net oil and gas income exceeds the excess intangible drilling costs but his share of the S corporation's net income alone would not exceed his share of its excess intangible drilling costs.267

The other change dealing with tax preference items made by the Revision Act gives shareholders the option to capitalize intangible drilling costs.268 This option also is available to partners in a partnership.269 If the shareholder elects to capitalize the intangible drilling costs they are no longer treated as tax preference items.270 Any S corporation shareholder may elect to amortize intangible drilling costs over a ten-year period.271 An S corporation shareholder who actively participates in the management of the corporation also has the option to deduct the intangible drilling costs over five years.272 The shareholder avoids any possible alternative minimum tax by using this option.273 The five-year option is not available to shareholders who do not actively participate in the management of the corporation.274 Either the five-year or ten-year option is beneficial to shareholders who would be liable for the alternative minimum tax and who would rather use the intangible drilling cost deductions in the future to offset expected income.275

IV. REMAINING DETERRENTS FOR THE OIL AND GAS INDUSTRY

Three other characteristics unique to subchapter S corporations made the subchapter S option unattractive to the oil and gas industry. They were the limitations on net operating loss deductions, the possibility of unintentional termination due to passive investment income, and the election, eligibility, and termination rules in general. While the Revision Act makes improvements in each area, the changes probably are not sufficient to make the S form widely attractive to the oil and gas industry in the future.

including oil and gas income, and items of deduction, including intangible drilling costs. See I.R.C. § 1366(a) (1982).

267. See Massoglia & Choate, supra note 147, at 104.
269. Id. § 58(f)(5)(D).
270. Id. § 58(f)(7).
271. Id. § 58(f)(1), (i)(2)(C).
272. Id. §§ 58(f)(4), 55(e)(8)(C).
273. Id. § 58(f)(7).
274. Id. §§ 58(f)(4)(C), 55(e)(8)(C).
275. See Massoglia & Choate, supra note 147, at 105.
A. Limitations on the Net Operating Loss Deduction

Under prior law, net operating losses were one of two items which passed through directly to shareholders on a daily basis in proportion to the amount of stock they owned and the number of days they owned it. The amount of the loss which could be deducted by any shareholder was limited to his adjusted basis in his stock and in any debt owed to him by the corporation. The stock and debt bases were determined as of the close of the taxable year and were increased for undistributed taxable income charged to the shareholder for that year. The rule limiting losses to the shareholder’s basis was similar to the partnership rule which limits a partner’s net operating loss deduction to the basis in his partnership interest.

However, two major differences existed between the partner’s loss limit and the shareholder’s loss limit. The first difference, mentioned above, was that unlike the partner, the shareholder could not consider as part of his stock basis his proportionate share of any indebtedness of the corporation to a third party. The second and more critical difference under prior law was that if the amount of the loss was more than the sum of the shareholder’s stock and debt basis, then that excess net operating loss deduction was lost permanently and could not be carried over to any later taxable year when the shareholder’s basis might have increased.

The Revision Act has eliminated only one of the differences. The shareholder still may deduct losses only to the extent of his basis in stock and corporate debt. The shareholder’s stock basis is increased by any corporate income taxed to him for the year, before the net operating loss limit is determined. Debt of the corporation to third parties still does not increase the shareholder’s basis. However, any

---

276. I.R.C. § 1374(a), (b) (1976) (repealed 1982).
277. Id. §§ 1374(c)(2).
278. Id.
279. Id. § 704(d) (1982).
280. Id. §§ 1376(a) (1976) (repealed 1982); see id. §§ 705, 722, 752 (1982); see supra notes 130-33 and accompanying text.
283. Id. §§ 1366(d)(1)(A), 1367(a)(1).
284. Id. § 1367(a). The rationale for the loss and basis limit remains the same despite the changes in the subchapter S provisions. "In subchapter S, the 'at risk' limitation denies a shareholder the net operating loss flow-through in excess of his investment in the corporation . . . in recognition that the corporate shield protects him from sustaining a financial loss beyond this..."
losses in excess of the shareholder’s basis no longer are permanently lost. Instead, the shareholder may carry over excess losses to succeeding years in which his basis is increased.\textsuperscript{285} Deductions for losses, therefore, are at most deferred.\textsuperscript{286} This provision is similar to the loss carryover provision for partnerships.\textsuperscript{287} The deferral provision may be an advantage to shareholders on occasion. If his actions are properly timed, the shareholder can contribute or loan money to the corporation, increasing his basis in his stock or in corporate debt, and the losses can flow through when the shareholder can best use them.\textsuperscript{288} If the shareholder does not want the losses to flow through, the corporation can repay its debt or return his contribution, reducing his debt basis and causing deferral of the loss deduction.\textsuperscript{289}

Compared to the partnership, however, the S corporation still is at a disadvantage because of the third party debt rule. When an oil or gas venture is to be financed largely with outside funds borrowed by the corporation, and large losses are expected initially, the S form will provide the expected tax benefits of the loss flow through only with careful planning. The S corporation losses will flow through only if the debt is incurred by the shareholders, who then loan or contribute the money to the corporation.\textsuperscript{290} But that arrangement is feasible only if direct borrowing by the shareholder is feasible.\textsuperscript{291} For the partnership, it is immaterial whether individual partners are able to borrow, thus making the partnership the more flexible form of operation.

B. Passive Investment Income

Prior to the Revision Act, a valid subchapter S election was automatically terminated if more than twenty percent of the corporation’s

\textsuperscript{286} Kanter, supra note 10, at 919.
\textsuperscript{287} I.R.C. § 704(d) (1982).
\textsuperscript{288} Katz, \textit{Subchapter S: A Step Toward Sanity}, 10 J. CORP. TAX’N 118, 127 (1983). The shareholder must, however, make an actual economic outlay to the S corporation in order to increase his basis. The Internal Revenue Service has ruled that a demand note issued by a shareholder to the S corporation did not increase the shareholder’s stock basis since the shareholder had no basis in the note he issued. Rev. Rul. 81-187, 1981-1 C.B. 167, 168.
\textsuperscript{289} Katz, supra note 288, at 127.
\textsuperscript{291} Id.
gross receipts\textsuperscript{292} for any taxable year consisted of passive investment income.\textsuperscript{293} The problem for the oil and gas industry was that passive investment income included “royalties,”\textsuperscript{294} which were defined to include oil and gas royalties.\textsuperscript{295} The termination of subchapter S status was retroactive to the start of the taxable year in which the passive investment income exceeded twenty percent.\textsuperscript{296}

Several commentators considered the passive investment income rule to be a leading cause of subchapter S termination.\textsuperscript{297} Inadvertent violations of eligibility rules resulting in retroactive termination was one of the traps the Revision Act attempted to eliminate.\textsuperscript{298} And indeed this problem has been eliminated for all S corporations which have no accumulated earnings and profits for years in which they were non-electing corporations. Thus S corporations which have always elected subchapter S status and S corporations which used to be non-electing corporations but have no leftover accumulated earnings and profits, cannot be inadvertently terminated because of excess passive investment income. The only corporations which can be terminated are those which have accumulated earnings and profits from their non-electing corporation years remaining after three consecutive years as an S corporation, and which have earned passive investment income that constituted more than twenty-five percent of their gross receipts for each of the three years.\textsuperscript{299} Passive investment income still includes gross receipts from royalties.\textsuperscript{300} The termination is no longer retroactive.

\textsuperscript{292} Gross receipts are the total amounts received by the corporation, not reduced for any costs or deductions. Treas. Reg. § 1.1372-4(b)(5)(iv), T.D. 7414, 1976-1 C.B. 266, 267.

\textsuperscript{293} I.R.C. § 1372(e)(3) (1976) (repealed 1982).

\textsuperscript{294} Id § 1372(e)(3)(C). Passive investment income also included gross receipts from rents, dividends, interest, annuities, and sales or exchanges of stock or securities. Id.

\textsuperscript{295} Treas. Reg. § 1.1372-4(b)(5)(v), T.D. 7414, 1976-1 C.B. 266, 267. There has been dispute about whether oil and gas royalties included production payments and overriding royalties. Compare United States v. 525 Co., 342 F.2d 759, 763 (5th Cir. 1965) (production payments are not royalties) with Treas. Reg. § 1.1372-4(b)(5)(v), T.D. 7414, 1976-1 C.B. 266, 267 (refers to Treas. Reg. § 543-1(b)(11)(ii) which defines mineral, oil, and gas royalties as including overriding royalties and production payments not considered loans under I.R.C. § 636).

\textsuperscript{296} I.R.C. § 1372(e)(3)(A) (1976) (repealed 1982). One exception to the termination rules was for subchapter S corporations in their first taxable year in which they commenced the active conduct of any trade or business or the very next year if the amount of passive investment income was less than $3,000. Id. § 1372(e)(3)(B). Active conduct of a trade or business included activities designed to allow the corporation to conduct business operations. Treas. Reg. § 1.1372-4(b)(5)(ii)(b), T.D. 7414, 1976-1 C.B. 266, 267.


\textsuperscript{298} S. REP. NO. 640, 97th Cong., 2d Sess. 6, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3258.

\textsuperscript{299} I.R.C. § 1362(d)(3) (1982).

\textsuperscript{300} Id. § 1362(d)(3)(D)(I).
tive and is effective on the first day of the taxable year following the third passive investment income year.\textsuperscript{301}

The Revision Act also imposes a tax on any S corporation which at the end of a taxable year has leftover accumulated earnings and profits from any year as a non-electing corporation and which had excess passive investment income during that year.\textsuperscript{302} The tax is imposed at the highest corporate tax rate, currently forty-six percent.\textsuperscript{303}

The passive investment income tax and termination provisions are retained by the Revision Act to prevent non-electing corporations from converting an operating company into a holding company not subject to a corporate level tax, and so avoiding the tax on accumulated earnings which would occur if the corporation were liquidated.\textsuperscript{304} However, the tax and termination provisions do pose major problems for non-electing corporations who innocently elect subchapter S status without any intention of tax avoidance by the conversion of an operating company into a holding company. The problem is a consequence of the difficulty of accurately calculating accumulated earnings and profits.\textsuperscript{305} In addition, there is no statute of limitations for determining the existence of accumulated earnings and profits.\textsuperscript{306} For example, an S corporation in good faith may determine that it has no leftover accumulated earnings and profits. A later audit may reveal, however, that it did have accumulated earnings and profits for three consecutive years, causing termination of its status as an S corporation.\textsuperscript{307}

The Revision Act has provided a remedy in cases of such an inadvertent termination.\textsuperscript{308} If an inadvertent termination occurs due to passive investment income and if shareholders and the corporation agree to make appropriate adjustments as required by the Internal Revenue

\textsuperscript{301} Id. § 1362(d)(3)(A)(i).

\textsuperscript{302} Id. § 1375(a). The tax is determined by multiplying the 46% corporate tax rate by the excess net passive investment income. Excess net passive investment income is the amount which bears the same ratio to net passive investment income for the taxable year as the amount by which passive investment income exceeds 25% of gross receipts for the taxable year bears to the passive investment income for the year. Net passive income is passive investment income reduced by allowable deductions directly connected to producing the income. Id. § 1375(a), (b).

\textsuperscript{303} Id. § 1375(a); see id. § 11(b).

\textsuperscript{304} S. REP. No. 640, 97th Cong., 2d Sess. 6, reprinted in 1982 U.S. CODE CONG. & AD. NEWS at 3258.

\textsuperscript{305} Shaw & August, An analysis of the Subchapter S Revision Act: eligibility, election, termination (pt. 1), 58 J. TAX'N 2, 7 (1983).

\textsuperscript{306} Id.


\textsuperscript{308} See I.R.C. § 1362(f) (1982).
Service, the corporation may continue to be treated as an S corporation.\textsuperscript{309} Congress has cautioned the IRS to be "reasonable" in granting waivers of termination.\textsuperscript{310} It has suggested that an appropriate adjustment for the passive investment income problem may be to treat the discovered accumulated earnings and profits as distributed and included in dividend income of the shareholder.\textsuperscript{311}

The passive investment income problem is eliminated for S corporations which have no earnings and profits history as a non-electing corporation. This will be a benefit to qualifying oil and gas S corporations since royalty income no longer poses a problem to them. Commentators have suggested that the S corporation could use royalty income to help finance drilling activity.\textsuperscript{312} Others have suggested that the passive investment income change will mean increased use of the S form in the oil and gas industry.\textsuperscript{313}

C. General Eligibility, Election, and Termination Requirements

Generally, the Revision Act has changed the S corporation eligibility, election, and termination rules to make the S status election more certain. In addition, new rules have generally broadened eligibility for S status and have mitigated the harsh impact of termination of S status.

Briefly, the eligibility requirements under the Revision Act are, first, that the corporation have no more than thirty-five shareholders.\textsuperscript{314} Under prior law, the limit was twenty-five.\textsuperscript{315} Second, as under prior law, every shareholder must be either an individual, an estate, or a qualified trust, and no corporation or non-resident alien may be a shareholder.\textsuperscript{316} Third, the corporation may have only one class of

\textsuperscript{309} Id.
\textsuperscript{310} S. REP. No. 640, 97th Cong., 2d Sess. 12, \textit{reprinted in} 1982 U.S. CODE CONG. & AD. NEWS at 3264.
\textsuperscript{311} Id. at 13, \textit{reprinted in} 1982 U.S. CODE CONG. & AD. NEWS at 3265.
\textsuperscript{312} Massoglia & Choate, \textit{supra} note 147, at 105.
\textsuperscript{313} Kanter, \textit{supra} note 10, at 884.
\textsuperscript{314} I.R.C. § 1361(b)(1)(A) (1982). A husband and wife are treated as one shareholder. \textit{Id.} § 1361(e)(1). The number 35 was chosen to bring the S corporation tax laws in line with the Regulation D private placement exemption of the Securities Act of 1933. S. REP. No. 640, 97th Cong., 2d Sess. 7, \textit{reprinted in} 1982 U.S. CODE CONG. & AD. NEWS at 3259. This was not accomplished, however, because while the private placement regulation allows 35 nonaccredited investors, it allows an unlimited number of accredited investors. See 17 C.F.R. 230.506 (1982).
\textsuperscript{316} \textit{Id.} § 1361(b)(1), (B) (1982); \textit{Id.} § 1371(a)(2), (3) (1976) (repealed 1982). A qualified subchapter S trust is one which has only one current income beneficiary and which meets various other requirements. \textit{Id.} § 1361(a)(3) (1982).
However, in a significant departure from prior law, differences in voting rights in stock will not mean that there is more than one class of stock. In addition, the Revision Act establishes a safe harbor for debt instruments, to prevent their recharacterization as stock for purposes of determining whether the corporation has more than one class of stock. The safe harbor is for “straight debt,” defined as any written, unconditional promise to pay on demand or on a set date a specific amount of money, with an interest rate that is not contingent on profits or other factors, and if the debt cannot be converted to stock. The fourth requirement is that the corporation cannot be a member of an affiliated group of corporations. That is, no corporation can be a shareholder of the S corporation, and the S corporation cannot be an eighty percent or more owner of another corporation, except for certain non-operating subsidiaries. Finally, certain corporations, including certain financial institutions and insurance companies, cannot be S corporations.

As under prior law, all shareholders must consent to the election of S status. An election of S status for a taxable year may be made on or before the fifteenth day of the third month of that year or in any preceding year. If the election is made on or before the fifteenth day of the third month but the corporation did not meet the eligibility requirements or all shareholders did not consent, the election is considered made for the following taxable year. An election will remain in effect until it is terminated due to revocation, ineligibility, or excess passive investment income. To revoke the election, shareholders holding more than one-half of the stock must consent to the revocation. The shareholders may specify the date on which the revocation is to take place. Termination due to ineligibility occurs when the corporation ceases to be an S corporation because it has more than

---

318. Id. § 1361(c)(4) (1982).
319. Id. § 1361(c)(5)(A).
320. Id. § 1361(c)(5)(B). Further, the creditor must be either an individual, an estate, or a trust. Id. § 1361(c)(5)(B)(iii).
321. Id. § 1361(b)(2)(A).
322. Id.; see id. §§ 1361(b)(1), 1504(a).
323. Id. § 1361(b)(2).
324. Id. § 1362(a)(2).
325. Id. § 1362(b)(1).
326. Id. § 1362(b)(2).
327. Id. § 1362(c).
328. Id. § 1362(d)(1)(B).
329. Id. § 1362(d)(1)(D).
thirty-five shareholders, more than one class of stock, or when its stock has been transferred to ineligible shareholders. The termination no longer is retroactive and is effective on or after the date the corporation ceases to be an S corporation. The inadvertent termination provisions apply to prevent loss of subchapter S status where the corporation unintentionally violated the provisions. Finally, unlike the prior rules, no person who becomes a shareholder after the subchapter S election is made, can terminate the election by a unilateral refusal to consent. Instead, the new shareholder is bound by the election, unless he owns more than half the stock.

The eligibility, election, and termination regulations adopted by the Revision Act are clearer and simpler than prior statutes. However, S corporation planners must be careful to insure that all the requirements are met. Moreover, the restrictions may be too unwieldy for an oil and gas operation. The requirement of only one class of stock prevents any special allocations of income or deductions based on kinds of stock. The straight debt rules similarly limit the kinds of shareholder financing the S corporation can use without fear of terminating its S status. In addition, the thirty-five shareholder limit eliminates the S form for operating a public drilling fund, in which many investors are sought.

V. S CORPORATION VERSUS PARTNERSHIP
AFTER THE REVISION ACT

The Subchapter S Revision Act has made many distinct improvements in the subchapter S provisions. The two most serious obstacles to use of the S form by the oil and gas industry have been eliminated: the percentage depletion problem and the irretrievable loss of any net operating losses in excess of bases. In many areas, the S corporation is equal to the partnership. For purposes of the percentage depletion deduction, the windfall profits tax, the pass-through of items of income, deduction, and credit and loss, the shareholder is treated almost the same as a partner. If the corporation has no carryover accumulated

332. Id. § 1362(d).
335. See Massoglia & Choate, supra note 147, at 105.
earnings and profits, the treatment is identical for distributions of everything except appreciated property.

However, major differences remain between the partnership and the S corporation, and most of the differences favor the partnership. As discussed above, a partner's basis in his partnership interest can be increased by the liabilities of the partnership to third parties. The shareholder's basis cannot be increased for S corporation debt to third parties. Since both partners and shareholders can deduct losses to the extent of their basis, the partner is allowed to deduct far more losses than the shareholder. This difference is critical to leveraged investments where losses are expected to be greater than the amount of money and property contributed.\(^{336}\)

The second major difference that benefits the partnership is the partnership's ability to specially allocate items of income, deduction, and loss to particular partners.\(^{337}\) The special allocation allows the oil and gas industry to efficiently handle farm-out arrangements—especially those involving two separate properties—and carried interest arrangements.\(^{338}\) To be effective, however, the special allocation must have "substantial economic effect." That means that the partner to whom an allocation is made must "receive the economic benefit or bear the economic burden or risk associated with the allocation."\(^{339}\)

The special allocation must be reflected in the partner's capital accounts, along with his contributions to the partnership and its distributions to him. The capital account or a partnership agreement which produces the same results must govern distribution of assets on liquidation of the partnership.\(^{340}\)

\(^{336}\) See Cantor & Brill, supra note 290, at 232.

\(^{337}\) I.R.C. § 704(b) (1982).

\(^{338}\) See Massoglia & Choate, supra note 147, at 105; see supra notes 202-10 and accompanying text.

\(^{339}\) Proposed Treas. Reg. § 1.704-1(b)(2)(ii) (1983). An allocation does not have "substantial" economic effect, however, if at the beginning of a taxable year, the special allocation is likely to cause tax consequences that are disproportionately large compared to the economic consequences. Id. § 1.704-1(b)(2)(iii).

\(^{340}\) Id. § 1.704-1(b)(2)(iv)(a), (b). It is uncertain exactly how specific the partnership agreement must be concerning the effect of the capital account at liquidation. See generally Allison v. United States, 701 F.2d 933, 939-40 (Fed. Cir. 1983) (partnership agreement did not require liquidation to reflect capital accounts and special allocation not upheld); Holladay v. Commissioner, 649 F.2d 1176, 1180 (5th Cir. 1981) (partnership agreement did not require liquidation to reflect capital accounts and special allocation not upheld); Hamilton v. United States, 687 F.2d 408, 409 (Cl. Cir. 1982) (partnership agreement specific and allocation upheld); Harris v. Commissioner, 61 T.C. 770, 785-86 (1974) (partnership agreement specific and allocation upheld); Orrisch v. Commissioner, 55 T.C. 395, 404 (1970) (partnership agreement not specific and allocation held to primarily affect tax liabilities of partners). For special allocations in the oil and gas industry see
S corporations also are burdened by the eligibility requirements which limit the size and the debt and equity structure of the corporation. Moreover, S corporations are at a disadvantage in any transfer of appreciated property, since gain must be recognized immediately to the corporation and its shareholders. Finally, any S corporation with leftover accumulated earnings and profits faces the possibility that distributions will be taxed as dividends, and S corporations with accumulated earnings and profits from years as a non-electing corporation face the possibility of an added forty-six percent tax on excess passive investment income and termination of their S status.

However, there are some instances in which the S corporation may be beneficial in the oil and gas industry. If the business has no accumulated earnings and profits history, if special allocations are not necessary, and if the business does not need to rely on heavy borrowing from third parties, the S corporation may have some distinct advantages. The classification of the business as a corporation for tax purposes is more certain than the classification of a partnership, especially a limited partnership. To qualify as a partnership, an entity can have no more than two of the corporate resemblance characteristics: (1) continuity of life, (2) free transferability of interests, (3) limited liability, and (4) centralized management. For the entity to be classified as a partnership the limited partnership agreement must be drafted carefully, and the general partner must be selected with care.

Tax considerations aside, the S corporation, as a corporation, can insure limited liability to all investors, provide true continuity of life and allow for free transferability of interests. The new provision allowing different voting rights can be used to assure that one share-
holder can control operations and management. Finally, there is the practical advantage that the law of corporations is more fully developed than the law of partnerships.

VI. CONCLUSION

The Subchapter S Revision Act of 1982 has vastly improved the rules governing S corporations and their shareholders. The changes have made the S corporation a much more viable form of organization for the oil and gas industry. Whether the S form will be used more widely by the industry after the Revision Act will depend on the needs of the individual oil and gas investors and operators.

Laurie Anne Patterson

349. See Kanter, supra note 10, at 914.
350. See Miller, supra note 10, at 262.