

Internal Revenue Service (I.R.S.)

Revenue Ruling

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Small business corporation; creation to avoid tax. The creation of a new domestic corporation to carry on a specific portion of the business of an existing domestic corporation for the primary purpose of gaining the benefits of subchapter 'S' is not tax avoidance within the meaning of section 269 of the Code.

Advice has been requested whether, under the circumstances described below, section 269 of the Internal Revenue Code of 1954 can be applied to disallow any deduction, credit, or other allowance resulting from an election by a corporation to be taxed as a small business corporation under subchapter S.

Corporation *M* was organized in 1967 to engage in the business of selling and distributing certain products. All of its capital stock was owned by *A*. As a convenience to some of its customers, *M* intermittently engaged in the sale and distribution of certain other unrelated products. In 1973 *A* organized corporation *X* to deal on a regular basis exclusively in these other products and *M* discontinued this part of its business. *X* elected, under section 1372 of the Code, to be taxed as a small business corporation under subchapter S of the Code. The principal purpose for the organization of *X* was to secure the benefits of subchapter S.

Section 1372 of the Code provides, in general, that any small business corporation may elect not to be subject to Federal income taxes. If such an election is made, then the income of the corporation is taxed to the stockholders whether distributed or not, and any ordinary corporate loss is passed through and deducted as a business loss by the stockholders. *See* sections 1373 through 1379.

Section 269(a)(1) of the Code provides, in part, that if any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that such person would not otherwise enjoy, then the Secretary or the Secretary's delegate may disallow such deduction, credit, or other allowance.

Section 1.269-2 of the Income Tax Regulations states, in part, that under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan that the deduction, credit, or other allowance was designed by Congress to effectuate.

In *Modern Home Fire and Casualty Insurance Co.*, 54 T.C. 839 (1970), *acq.*, 1970-2 C.B. xx, the United States Tax Court held that, even if the principal purpose in organizing an electing small business corporation was to allow a shareholder to offset the shareholder's losses against the corporation's undistributed taxable income, the enjoyment of this benefit would be consistent with the intent of Congress to allow shareholders of electing small business corporations to 'be taxed directly on the corporation's earnings' and to report 'corporate income (whether or not distributed) as their own for tax purposes,' *S. Rep. No. 1983*, 85th Cong., 2d sess. 87 (1958), and thus cannot be regarded as tax avoidance by securing a benefit the taxpayer would not otherwise enjoy.

Accordingly, although *A*'s principal purpose in creating *X* was to secure the benefit of exemption from the corporate income tax, section 269 of the Code does not apply to disallow any deduction, credit, or other allowance resulting from an election by a corporation to be taxed as a small business corporation under subchapter S.

See also Rev. Rul. 70-238, 1970-1 C.B. 61, which holds that the deliberate creation of a subsidiary for the express purpose of qualifying it as a Western Hemisphere Trade Corporation under section 921 of the Code does not amount to tax avoidance within the meaning of section 269 and states that Congress intended to make the special deduction provided by section 922 available to any domestic corporation provided only that it could satisfy the specific requirements of section 921. The same principles are involved in the instant case.