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Revenue Ruling 59-221

January 1959

SECTION 1402.-DEFINITIONS

Where a small business corporation elects under section 1372 of the Internal Revenue Code of 1954 not to be subject to Federal income tax, the amounts of its income which are required to be included in each shareholder's gross income do not constitute "net earnings from self-employment" to such shareholder for Self-Employment Contributions Act purposes.

Advice has been requested whether the undistributed taxable income required to be included in the gross income of shareholders of a small business corporation which has made an election pursuant to subchapter S of the Internal Revenue Code of 1954 not to be subject to Federal income tax, constitutes net earnings from self-employment to the shareholders for purposes of the tax imposed under the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954.)

Section 64 of the Technical Amendments Act of 1958, Public Law 85-866, 72 Stat. 1606, at 1650, added subchapter S to chapter 1 of the Internal Revenue Code of 1954, effective for taxable years beginning after December 31, 1957. This subchapter contains sections 1371-1377 of the Code which pertain to the election of certain small business corporations as to taxable status.

Section 1372 of this subchapter provides, in effect, that any small business corporation, as defined in section 1371, may elect not to be subject to the income tax imposed by chapter 1 of the Code.

Section 1373 of the Code provides that each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for its taxable year. This section provides further that an amount so included in a shareholder's income shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

Section 1402 of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954) provides in part as follows:

- (a) **NET EARNINGS FROM SELF-EMPLOYMENT.**-The term "net earnings from self-employment" means the gross income derived by an individual from any

trade or business carried on by such individual, less the deductions allowed by this subtitle [subtitle A] which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a) (9) from any trade or business carried on by a partnership of which he is a member; * * *

* * *

- (c) **TRADE OR BUSINESS.**-The term "trade or business," when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 * * *

From the above-defined terms it is apparent that income not resulting from the conduct of a trade or business by an individual or by a partnership of which he is a member is not includible in computing the individual's net earnings from self-employment. Amounts which must be taken into account in computing a shareholder's income tax by reason of the provisions of section 1373 of the Code, are not derived from a trade or business carried on by such shareholder. Neither the election by a corporation as to the manner in which it will be taxed for Federal income tax purpose nor the consent thereto by the persons who are shareholders results in the consenting shareholder's being engaged in carrying on the corporation's trade or business. Accordingly, amounts which a shareholder is required to include in his gross income by reason of the provisions of section 1373 of the Code should not be included in computing his net earnings from self-employment for Self-Employment Contributions Act purposes.