S CORPORATION REFORMS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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S CORPORATION REFORMS

THURSDAY, JUNE 19, 2003

U.S. House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The Subcommittee met, pursuant to notice, at 12:35 p.m., in room B–318, Rayburn House Office Building, Hon. Jim McCrery (Chairman of the Subcommittee) presiding.

[The advisory and the revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
June 19, 2003
SRM–2

McCrery Announces Hearing on S Corporation Reforms

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on S Corporation reforms. **The hearing will take place on Thursday, June 19, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

An S corporation is an incorporated business whose shareholders enjoy limited liability from debts but also elect to be treated as a pass-through entity, meaning that the business does not pay corporate level tax. Instead, income, losses, and credits are generally taxed at the individual shareholder level.

S corporations must comply with several restrictions, violations of which can result in the loss of S corporation status. Those restrictions include a limit on the number and type of shareholders, a restriction to one class of stock, and from being a member of a consolidated group. These restrictions can trap the unwary with serious consequences to the business and to its shareholders.

Several bills have been introduced this Congress, which address many of the problems S corporations and their shareholders face. These bills include the following: H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," introduced by Rep. Scott McInnis (R–CO); H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," introduced by Rep. Jim Ramstad (R–MN); and H.R. 1896, the "Subchapter S Modernization Act of 2003," introduced by Rep. E. Clay Shaw, Jr., (R–FL). This hearing will give the Subcommittee a better understanding of this Subchapter in the U.S. Tax Code and possible reforms to it.

In announcing the hearing, Chairman McCrery stated, "As a supporter of the President's plan to eliminate the double-taxation of corporate dividends, I believe it would be preferable if the U.S. Tax Code subjected corporate earnings to only one level of tax. Pass-through entities, including Subchapter S corporations, achieve that objective. However, the rules and restrictions on these entities may unnecessarily inhibit their growth. This hearing will give the Subcommittee an opportunity to explore the manner in which we regulate these businesses and possible approaches to reform, like the ones introduced by our colleagues on the Committee."

FOCUS OF THE HEARING:

The focus of the hearing is to discuss proposals to simplify Subchapter S and to allow S corporations greater flexibility to access the capital markets.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Thursday, July 3, 2003. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://*waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

*** * * NOTICE—CHANGE IN TIME AND LOCATION * * ***

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
June 19, 2003
SRM–2–REVISED

CONTACT: (202) 226–5911

Change of Time and Location for Hearing on S-Corporation Reform

Congressman Jim McCrery (R–LA), Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the hearing on S-Corporation Reform, previously scheduled for Thursday, June 19, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m., will be held, instead **in room B–318 Rayburn House Office Building, immediately following the completion of the full Committee mark up of H.R. 2351, the "Health Savings Account Availability Act."**

All other details for the hearing remain the same. (See Subcommittee Advisory No. SRM–2 released on June 12, 2003.)

Chairman MCCRERY. The hearing will come to order.

Good afternoon, everyone. I am sorry about the late start of the hearing. We were delayed, of course, by the markup of the full Committee, but we are now ready to begin. I have an opening statement, which I will submit for the record in order to save us a little time.

We do have one witness on the second panel who has some time constraints with regard to her flight back home, so we are going to allow her to be the first witness. She happens to be from the State of Minnesota, so I am going to allow our colleague on the Committee on Ways and Means, Mr. Ramstad, to introduce her.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Honorable Jim McCrery, Chairman, and a Representative in Congress from the State of Louisiana

Today, the Subcommittee on Select Revenue Measures will hear testimony on the rules and regulations surrounding S corporations, an organizational entity used by millions of small businesses.

Subchapter S of the Internal Revenue Code was originally enacted in 1958 and has been revised several times since then, most recently in the Small Business Job Protection Act of 1996. Despite subsequent improvements to this regulatory structure, questions have been raised about whether Subchapter S has kept pace with the way businesses structure themselves today and whether it inappropriately restricts the growth and expansion of the small businesses it was meant to foster.

Unlike C corporations, businesses organized under Subchapter S are considered "pass-through" entities. Income and losses are not taxed at the corporate level. Instead, they are passed through directly to shareholders who pay taxes on that income at individual income tax rates.

Data provided by the Joint Tax Committee shows the rapid growth of these entities primarily. In 1978, only 3% of business returns were made by S corps. By 1989, that figure had doubled. And by 2000, it had nearly doubled again, reaching 11%.

Despite the increasing popularity of this filing status, S corps remain a favored entity for small businesses, though there are clearly some large S corps and small C corporations.

The President's growth plan called for subjecting C corporation earnings to only a single level of tax. And while the tax cut eventually adopted fell short of that goal, it highlighted the efficiency benefits of subjecting income to only one level of tax.

In that sense, pass-through entities, including partnerships and businesses organized under Subchapter S, embody the President's goal of taxing corporate income only one time.

Unfortunately, there are provisions in the tax code which place unreasonable limits on Subchapter S corporations. This hearing will give us an opportunity to review those provisions and to evaluate whether the tax policy rationale for them justifies the shackles they can place on growing businesses and entities which either are already an S-corp or, particularly in the case of banks, which want to become S corps.

For example, S corps may have only a limited number of shareholders. They may not issue multiple classes of stock. Their stock may be held by neither IRAs nor nonresident aliens.

Other rules represent traps for the unwary which may cause an S-corp to lose that status.

These and other background issues were thoroughly presented in a background memo prepared by the Joint Committee on Taxation, which was distributed to all of the Members yesterday.

The document, number JCX–62–03, is available on the Joint Committee's web page, and I commend it to anyone who wants a background on Subchapter S.

This year, several of our colleagues on the Committee on Ways and Means have introduced measures to reform these rules. Mr. Shaw and Mr. McInnis have introduced bills which deal comprehensively with these rules, and those measures will get extensive discussion today.

So, too, will a bill introduced by Mr. Ramstad which would address the so-called "built-in gains" tax which S corps face if they sell an asset acquired when it was organized as a C corporation. The bill would waive the built-in gains tax if the S-corp reinvested the proceeds of the sale.

Today's hearing will provide us with an opportunity to examine and evaluate these proposals.

A fourth S corp bill which is not being discussed today but which should be mentioned was introduced by the Chairman of the Oversight Subcommittee, Amo Houghton. His bill would collapse the S-corp and partnership tax systems.

While beyond the scope of this hearing, his suggested approach of consolidating pass-through entities is something this Committee may want to examine should we have an opportunity to make good on the President's goal of eliminating double-tax on corporate earnings.

Helping us sort through these difficult issues will be a distinguished panel of witnesses, including a fellow Louisianan, Rusty Cloutier from Lafayette.

Before we get to our public witnesses, however, we will hear from Greg Jenner, Deputy Assistant Secretary of the Treasury for Tax Policy. I look forward to the Administration's analysis of this issue.

But before we hear from him, I yield to Mike McNulty, my friend and the ranking member of the Subcommittee, for any opening statement he wishes to make.

Mr. RAMSTAD. Thank you, Mr. Chairman. I would ask unanimous consent that my statement also be included in full in the record.

I just want to say, briefly, Mr. Chairman, I want to thank you for holding this important hearing on proposed reforms to Subchapter S of the Tax Code. You have been a true leader in this area, and I appreciate your highlighting among the three bills here today, the Small Business Opportunity and Growth Act, H.R. 1498, which I have sponsored, along with several other Committee on Ways and Means Members. This legislation would relieve S corporations from the double tax, the built-in gains, as long as the proceeds of the asset sale are driven right back into the business.

It is a true stimulus. It would allow S corporations to immediately unlock capital and to create jobs. It is important legislation, and I am glad to welcome to the Subcommittee a long-time friend of mine, a very highly respected person in the business community of Minnesota, Kristen Copham, who is the Director of Liberty Enterprises in Mounds View, Minnesota, on behalf of the S Corporation Association (S-Corp).

It has been a true privilege working with Ms. Copham and her father, David Copham, and others at Liberty Enterprises on these issues, and I want to welcome you, Kristen, to the Subcommittee hearing today. Thank you, Mr. Chairman.

[The opening statement of Mr. Ramstad follows:]

Opening Statement of the Honorable Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for holding this important hearing on proposed reforms to Subchapter S of the tax code, which governs S corporations. I salute Mr. Shaw and Mr. McInnis for their leadership on these important issues. I also thank Kristen Copham, from Minnesota, for testifying here today.

As you know, there are nearly 3 million S corporations in America, most of which are small businesses. Small businesses are critical to job growth. That's why we must remove shackles that prevent S corporations from living up to their full potential and creating jobs.

I have introduced the Small Business Opportunity and Growth Act (H.R. 1498), along with several other Ways and Means members. Several of these cosponsors have co-signed a letter to you, Mr. Chairman, in strong support of this legislation. I would ask that this letter be made part of the hearing record.

Most of us think of S corporations as paying only one layer of tax, at the shareholder level. But my legislation addresses an onerous double tax on S corporations that is preventing many of them from growing and creating jobs.

When C corporations convert to S corporation status, they are trapped in a 10-year period in which any asset they held as a C corporation is subject to an onerous "built-in gains" tax when they sell it. The built-in gains tax combined with any applicable shareholder taxes can push the effective tax rate on asset sales above 70% in some states. As a result, S corporations are forced to sit on unproductive assets that could be better repositioned to build the business and create jobs.

My legislation would relieve S corporations from the double tax of built-in gains, as long as the proceeds of the asset sale are driven right back into the business. This will allow S corporations to immediately unlock capital, grow and create jobs.

An impressive coalition of groups with small business members has endorsed H.R. 1498, including the S Corporation Association, National Association of Manufacturers, U.S. Chamber of Commerce, National Association of Realtors and Independent Community Bankers. Some of these groups are represented here today, and I look forward to their testimony.

I am also pleased that the Bush Administration earlier this year proposed providing built-in gains relief through its proposal that would have ended the double taxation of dividends. Although no built-in gains relief was enacted in the dividend legislation that recently passed Congress, I look forward to working with the Bush Administration and my colleagues on ending unfair double taxation like the built-in gains tax that is stifling job creation.

Thank you again, Mr. Chairman, for holding this important hearing.

Chairman MCCRERY. Thank you, Mr. Ramstad.

Ms. TUBBS JONES. Mr. Chairman, can I at least greet you on behalf of the Democratic side?

Chairman MCCRERY. Sure.

Ms. TUBBS JONES. I have an opening statement that I will submit for the record. Thank you, Mr. Chairman.

[The opening statement of Ms. Tubbs Jones follows:]

Opening Statement of the Honorable Stephanie Tubbs Jones, a Representative in Congress from the State of Ohio

The Subcommittee on Select Revenue Measures is holding its second hearing this year to examine proposals to change the tax law rules applicable to "S" corporations. This form of tax structure allows a business to elect to be treated as a pass-through entity, thus providing that any profit or loss generated by the "S" corporation is taxed at the individual shareholder level. Many older, small businesses have incorporated as an "S" corporation for tax purposes. More recently, firms have organized under a partnership arrangement such as a limited liability corporation (LLC). Even with the increasing popularity of LLCs, it is important that we continue to monitor the tax rules for "S" corporations to insure that this valuable entity choice works for our longstanding, family-owned small businesses.

The Subcommittee's hearing will give us an opportunity to discuss the appropriateness of various corporate structures in today's economy and the details of several pending bills to reform the tax rules for "S" corporations. The bills we will discuss are H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," and H.R. 1896, the "Subchapter S Modernization Act of 2003."

There is bipartisan support for features of these bills. Further, related proposals were included in the Senate-passed version of "The Jobs and Growth Tax Relief Reconciliation Act of 2003" but dropped in the conference agreement. I will be particularly interested in the views of the Department of the Treasury as we proceed in considering the proposals.

The bills under consideration today are being promoted as simplification measures, reforms to improve access to capital by small businesses, and changes to preserve family-owned businesses. These are appropriate issues for the Subcommittee to consider. I commend Subcommittee Chairman McCrery for holding this hearing. As always, I look forward to followup discussions concerning these bills on a bipartisan basis.

Chairman MCCRERY. Yes, ma'am. Thank you. Ms. Copham, you have submitted to the Committee written testimony which will be entered into the record. I would ask you now, in about 5 minutes, to summarize that statement. You may proceed.

STATEMENT OF KRISTEN COPHAM, LIBERTY ENTERPRISES, MOUNDS VIEW, MINNESOTA, ON BEHALF OF THE S CORPORATION ASSOCIATION

Ms. COPHAM. Thank you, Chairman McCrery, and Members of the Subcommittee. I appreciate you being flexible for me.

Good morning. I am Kristen Copham from Liberty Enterprises testifying on behalf of the S-Corp. Liberty is headquartered in Minnesota, and we provide financial institutions nationwide with goods and services such as checks, marketing services, and Internet banking.

My brother and I are both second-generation owners of Liberty, and we hope that Liberty remains an S corporation for generations to come. We are also lucky enough to be an employee-owned company with over 600 employees who are proud to call themselves employee owners through our employee stock ownership plan (ESOP).

We are a founding member of S-Corp, which represents a large and growing portion of the 2.9 million S corporations around the country.

Thank you for holding this hearing to consider legislation that will benefit S corporations, which tend to be small and family-owned businesses. Congress created the Subchapter S structure to promote entrepreneurship by linking corporate taxes to owners, and S corporations have become American success stories as a result.

S-Corp has two legislative priorities this Congress.

First, we support Congressman Ramstad's bill, and we appreciate all of the work he has done with the Small Business Growth and Opportunity Act, introduced with 11 co-sponsors. The title sums up what this bill is all about: growth and opportunity for the S corporations struggling under the built-in gains tax burden that limits access to existing capital for growth and job creation.

H.R. 1498 will allow S corporations to liquidate certain unproductive assets and quickly reinvest the proceeds back into our business. Under current law, businesses that convert from C corporation to S corporation status are penalized for 10 years if they sell any asset that has a built-in gain. This penalty makes the sale and reinvestment of those assets prohibitively more expensive for S corporations, effectively forcing our businesses to retain those unproductive assets rather than face a double-tax burden.

In some States, this burden consists of Federal and State corporate taxes, plus Federal and State shareholder taxes, and can exceed 70 percent of the gain. Clearly, this is unsustainable and limits our cash flow, liquidity, and ability to reinvest in order to grow the business and create jobs.

Members of the Committee who have co-sponsored Congressman Ramstad's bill have signed a letter to Chairman McCrery in support of built-in gains tax relief which I understand will be included in the hearing record.

[The information follows:]

U.S. House of Representatives
Washington DC, 20515
June 18, 2003

The Honorable Jim McCrery
Chairman
Subcommittee on Select Revenue Measures
Ways and Means Committee
1135 Longworth
Washington, D.C. 20515

Dear Chairman McCrery:

Thank you very much for scheduling a Subcommittee hearing on S corporation legislation on June 19. As cosponsors of **H.R. 1498, *the Small Business Opportunity and Growth Act of 2003,*** we strongly support Ways and Means Committee efforts to consider and approve legislation that benefits S corporations this year.

As you know, H.R. 1498 will allow S corporations to liquidate certain unproductive assets and quickly reinvest the proceeds back into their businesses. Under current law, businesses that convert from C corporation to S corporation status are penalized for a period of 10 years if they sell any of their pre-S corporation assets, even if the proceeds are driven right back into the business. This "built-in gains" tax penalty makes the sale and reinvestment of these assets prohibitively expensive for these small companies. In some states, this double-tax burden combined with state and federal shareholder taxes can exceed 70% of the built-in gain.

Clearly, this is unsustainable. The built-in gains tax limits the S corporation's cash flow, its liquidity, and its ability to invest in order to grow its business and create jobs. The current tax code forces these businesses to hold on to unproductive and inefficient assets or face the double tax burden of the built-in gains tax.

At a time when Congress and the Administration have taken a stand against "double tax burdens" by cutting taxes on dividends, we would ask that you assist us in our efforts to remove this onerous double tax penalty on S corporations so these small businesses can grow, create jobs and help stimulate economic growth.

Thank you very much for your consideration of this important issue.

Sincerely,

Jim Ramstad
Member of Congress

Philip M. Crane
Member of Congress

Dave Camp
Member of Congress

Phil English
Member of Congress

Mark Foley
Member of Congress

We are grateful to these co-sponsors for their efforts on behalf of S corporations. This year Congress and the Administration have taken a stand against "double tax burdens" by cutting taxes on dividends, and we would ask that you also assist S corporations so we too can help stimulate economic growth.

Second, S-Corp applauds Congressmen Shaw and Matsui for again introducing H.R. 1896, which is the Subchapter S Modernization Act. This bill would remove unnecessary and obsolete restrictions to help small businesses grow and prosper and also puts us on a level playing field with other entity structures such as limited liability companies (LLCs).

S-Corp supports all of the provisions in H.R. 1896, but our top priorities include:

- Section 101 to count family members as one shareholder, which helps family-owned S corporations plan for the future without fear of termination of their S corporation election.
- Section 204 to modify passive income rules which would improve capital formation opportunities and eliminate unnecessary traps for S corporations.
- Section 201 to permit S corporations to issue qualified preferred stock. Current law permits us to have only one class of stock, which presents a serious problem for raising venture capital, for example.
- Section 202 to permit S corporations to issue debt that may be converted into stock of the corporation. All other entity structures are allowed to access such types of capital.
- Section 205, relating to charitable giving, places S corporations on par with other pass-through entities and promotes charitable giving activities.
- Title Four, we hope to see meaningful expansion of the rules regarding S corporation eligibility for banks.

Many of these provisions I have described were included in the Senate version of the Jobs and Growth Act, but were unfortunately removed in conference. We are hopeful that another viable tax vehicle can be found this year to enact these positive changes.

Finally, there is one more very critical issue that S-Corp wishes to bring to the attention of the Committee, and it may eventually require a legislative solution.

In the 2001 *Gross v. Commissioner of Internal Revenue* case in the Sixth Circuit, the Internal Revenue Service (IRS) successfully retroactively changed stock valuation rules for S corporations. These rules artificially increase the value of S corporations for estate and gift tax purposes. The IRS position in *Gross* overturns longstanding accepted valuation methods.

It has been estimated this change could unfairly raise, by as much as 40 percent, the tax bill for many S corporation owners. As the Committee knows, this estate tax burden could result in small and family-owned businesses having to sell the business just to pay the tax bill.

If the IRS continues to apply *Gross* in other circuits as a mandate on S corporation valuations, all of the positive and beneficial work done for S corporations by the Committee for income tax purposes will be lost.

S-Corp will be approaching the U.S. Department of the Treasury to determine if a moratorium on this decision is possible and would appreciate the support of Congress in this endeavor.

I thank the Committee for inviting me to testify this morning and for being flexible, and S-Corp looks forward to continuing to work with you. Thank you.

[The prepared statement of Ms. Copham follows:]

Statement of Kristen Copham, Liberty Enterprises, Mounds View, Minnesota, on behalf of the S Corporation Association

Chairman McCrery, Ranking Member McNulty and Members of the Subcommittee:

Good morning. I am Kristen Copham from Liberty Enterprises testifying on behalf of the S Corporation Association ("S-CORP"). Liberty Enterprises, headquartered in Mounds View, Minnesota, provides financial institutions and their customers with a number of goods and services including checks, financial supplies, market research, data processing, Internet banking, and bill payment. Liberty partners with more than 5,400 credit unions nationwide.

Liberty is a family and employee-owned company with over 800 employees. Liberty is a founding member of S-CORP which represents a large and growing portion of the 2.9 million Subchapter S businesses around the country.

I want to thank you for holding this hearing to consider legislation that will benefit S corporations by removing rules and restrictions that inhibit our growth. As you know, S corporations tend to be small and family-owned businesses. Congress created the Sub S structure to promote entrepreneurship by linking corporate taxes to owners in the early 1950s, and S corporations have become major success stories as a result.

S-CORP has two primary legislative priorities this Congress. First, S-CORP members support Congressman Ramstad's bill, H.R. 1498, the Small Business Growth and Opportunity Act, that he introduced on March 27th along with eleven original cosponsors. I think the title aptly sums up what this bill is all about providing for the S corporations struggling under the built-in gains tax burden and providing an opportunity for these businesses to access their existing capital for growth and job creation.

H.R. 1498 will allow S corporations to liquidate certain unproductive assets and quickly reinvest the proceeds back into our businesses. Under current law, businesses that convert from C corporation to S corporation status are penalized for a period of ten years if they sell any asset that has built in gain as of the date of conversion, even if the proceeds are driven right back into the business. This "built-in gains" tax penalty makes the sale and reinvestment of these assets prohibitively expensive for S corporations, effectively forcing our businesses to retain unproductive and inefficient assets rather than face a double-tax burden. In some states, this double-tax burden (i.e., the federal and state corporate level built-in gains tax plus the mandatory additional federal and state shareholder taxes) can exceed 70% of the gain. Clearly, this is unsustainable and limits the corporation's cash flow, liquidity, and ability to invest in order to grow the business and create jobs.

The built-in gains tax also impacts the ability to keep privately-held businesses in the hands of private buyers. Generally, because of the tax, if a company is to change hands, the transaction must be structured as a stock sale to minimize the seller's tax. More often than not this results in a public company buyer.

Several of the Ways and Means Members who have cosponsored Congressman Ramstad's bill have signed a letter to Chairman McCrery in support of built-in gains tax relief which I would ask be included in the hearing record. We are grateful to all of these cosponsors for their efforts on behalf of S corporations. At a time when small business has inordinate difficulty in raising and forming capital to expand and create jobs, Congressman Ramstad's proposal would allow S corporations to access the capital and assets that are already available to the S corporation, without onerous tax burdens, and in a targeted way that requires reinvestment in the business. This year Congress and the Administration have taken a stand against "double tax burdens" by cutting taxes on dividends. We would ask that you assist S corporations so we too can help stimulate economic growth.

Second, S-CORP applauds the persistence of Congressmen Shaw and Matsui to pass H.R. 1896, the Subchapter S Modernization Act, that they have again introduced this Congress. This bill includes a number of provisions to remove unnecessary and obsolete restrictions and help small businesses grow and prosper. S-CORP supports all of the provisions in H.R. 1896, but our top priorities include:

- Section 204 to modify passive income rules. This section would improve capital formation opportunities for small businesses, preserve family-owned businesses and eliminate unnecessary and unwarranted traps for taxpayers.
- For example, one of our member companies, a small family-owned hotel company in the San Francisco area, has been an S corporation for twelve years and during that time has failed the excess passive income tests at least twice. In 2002, the company failed the excess passive income test as the result of a merger of a local bank investment. The company realized a large capital gain as a result of this merger and failed the excess passive income test even though they had no control over the circumstances which resulted in the capital gain. The significant detrimental effect of this example is not so much the paying of the excess passive income tax, but the fear of failing the test three years in a row and losing the company's Subchapter S corporation election. A profit-making entity should not have to regulate the nature of its profits for fear of losing S status. Because the company was previously a Subchapter C corporation it is subject to the excess passive income rules. The tax code is not consistent with regard to the application of the excess passive income sections. Corporations that elect Subchapter S status from their creation are not subject to these tests or their resulting tax effects and losing their Subchapter S status.

Other provisions we would like to highlight include:

- Section 201 to permit S corporations to issue qualified preferred stock. Under current law, an S corporation is permitted to have only one class of stock. This presents a serious problem for S corporations seeking venture capital.
- Section 202 to permit S corporations to issue debt that may be converted into stock of the corporation. All other entity structures are allowed to access such types of capital. These provisions would put S corporations on an equal footing.
- Section 205 relating to charitable giving places S corporations on par with other pass-through entities and promotes charitable giving activities. S-CORP understands that Congress will again consider charitable giving tax incentives this year and hopes that changes can also be made on behalf of S corporations.
- Title Four—we hope to see meaningful expansion of the rules regarding S corporation eligibility for banks which the Committee will hear/has heard more about from another witness testifying today.

Many of these provisions were included in the Senate version of the Jobs and Growth Act, but were unfortunately removed in Conference. We are hopeful that another viable tax vehicle can be found this year to enact these positive changes for S corporations.

Finally, there is one more important issue that S-CORP wishes to bring to the attention of the Committee that may eventually require a legislative solution. In the 2001 case of *Gross v. Commissioner of Internal Revenue*, 272 F. 3d 333 (6th Cir. 2001), the IRS successfully retroactively changed stock valuation rules for S corporations which would artificially increase the value of S corporations for estate and gift tax purposes. The IRS position in Gross overturns longstanding accepted valuation methods.

It has been estimated this change could unfairly raise—by as much as 40 percent—the tax bill for many S corporation owners. As the Committee knows, this estate tax burden could result in many small and family-owned businesses having to sell the business just to pay the tax bill.

The 6th Circuit upheld the IRS position and the Supreme Court denied the *Gross* petition last year. S-CORP submitted a brief to the Court in support of the petitioners and was joined in the brief by numerous trade groups with S corporation members including the National Association of Manufacturers (NAM) and the National Federation of Independent Business (NFIB). S-CORP has learned that the IRS is seeking to enforce *Gross* in other Circuits. S-CORP will be approaching the Department of Treasury to determine if a moratorium to this decision is possible and would appreciate the support of Congress in this endeavor.

If the IRS continues to apply *Gross* as a mandate on S-corporation valuations, all the positive and beneficial work done for S corporations by the Committee for income tax purposes will be lost to the burdensome estate and gift tax regime.

I thank the Committee for inviting me to testify this morning and S-CORP looks forward to continuing to work with you.

Chairman MCCRERY. Thank you, Ms. Copham. In the Ramstad bill, there are some anti-abuse provisions. Can you just give us a quick synopsis of what those are, and why do you think they would ensure that C corporations do not convert to S corporations solely to avoid the built-in gains taxes?

Ms. COPHAM. Thank you, Mr. Chairman. These provisions, this bill has been carefully crafted to help avoid using these changes just to pay dividends to the shareholders. For any asset that is liquidated, that cash must be reinvested back into the business, either through paying down debt and helping the company in that way. A lot of S corporations have really increased their debt over the last few years, and also through purchasing other capital assets that would hopefully, of course, create more jobs and would be plowed back into the business.

They only have a year to do this, and if they don't do this, then the tax would kick back in. They would also be given a 10-percent penalty, as well as have to pay interest on that tax, so it is pretty stiff.

Chairman MCCRERY. Thank you. Ms. Tubbs Jones?

Ms. TUBBS JONES. I will be very brief. Good afternoon. How are you?

Ms. COPHAM. Fine. Thank you.

Ms. TUBBS JONES. Good. Good. In an earlier hearing—and if you don't mind, Mr. Chairman, she is a small business—I am just curious what do you do about health care for the people who work for you?

Ms. COPHAM. Well, Liberty is extremely progressive, in terms of health care. We have some of the best health care available, even compared to Fortune 500 companies, and part of that I think is because we, as a family, and the employees, take such pride in the company, and you know the company is us, essentially, and the employees have a very good understanding of that.

We have a very good, we actually have two levels of health insurance for our employees. So, they can elect to either pay more up front or less up front, and that will affect what kind of payment they will have to make as a deductible. Our plan, in particular, is very strong and on par with Fortune 500 companies, and I think it is really a result of being the kind of company we are.

Ms. TUBBS JONES. Is your status as a Subchapter S corporation impacted at all by what you are able to offer to your employees in a health care plan?

Ms. COPHAM. I believe it does. We basically——

Ms. TUBBS JONES. I hope that question came out right, but anyway, go ahead.

Ms. COPHAM. I think the fact that we are an S corporation gives us more flexibility and a longer term view, where we tend to our employees again, the ESOP is a shareholder, and we need to take care of our employees, with that long-term view in mind, so we have among the best health care available.

Ms. TUBBS JONES. Is there anything else you would like to say to this Committee? I am going to give you the rest of my few minutes to talk about anything else you haven't had a chance to talk about so far?

Ms. COPHAM. Well, I just want to thank you for considering these provisions, and it is very important that the S corporation legislation is updated and modernized. Also that the provision is changed in terms of the built-in gains so that we don't have double-tax burdens for those C corporations that change to S corporations.

I just want you to know that we have been an S corporation actually since our founding in 1985, when my father started Liberty, so this is a provision that doesn't even affect us directly. However, to level the playing field, I think it is fair and important that it is equal for all S corporations. So, I really appreciate the work done there, and I think it is the right thing to do.

Chairman MCCRERY. Mr. Ramstad?

Mr. RAMSTAD. Very briefly, Mr. Chairman. Again, I want to thank you for your courtesies, Mr. Chairman, with respect to this witness, and thank you, again, Ms. Copham, for coming here to testify.

In your testimony, you highlighted the importance of addressing the onerous built-in gains tax, which we have been discussing. Could you give us any specific illustrations or examples of how the built-in gains tax has negatively impacted S corporation businesses.

Ms. COPHAM. Thank you, Congressman Ramstad. Basically, if a company switches from C corporation status to S corporation status, they are going to have to pay these gains taxes on any unproductive asset that they choose to liquidate for 10 years. As a businessperson, I can tell you that assets tend to, on occasion, need to be liquidated and updated, as technology becomes available and whatnot. So, it becomes necessary to liquidate those assets in order to modernize your facilities or what have you.

So, it only makes sense that if a company has an unproductive or inefficient asset, they would want to modernize that, but they don't have to sell that, pay a double tax on the gain because they are already paying the corporate taxes on that gain, and then also pay a gains tax on that gain in order to put it back into the business. So, they are actually prohibited from making that sale.

Mr. RAMSTAD. It is quite clear to you, I am sure, that the requirement of reinvestment in the bill would certainly work to create jobs.

Ms. COPHAM. Oh, absolutely. I think there are two ways that can happen. First of all, reinvesting that money in order to pay down debt obviously helps free up moneys for making payroll and those kinds of things; and, second, reinvesting in other capital assets in order to expand the business and create more jobs.

Mr. RAMSTAD. Thank you again for coming here to testify. Thank you, Ms. Copham, for your leadership on behalf of S-Corp businesses across America. Your business, and I am sure you would invite not only the Chairman, but the Ranking Member here today, to view your business, to talk to your employee owners.

I have never been to a business, I can honestly say to my distinguished colleague, the Ranking Member here today, where the employee owners feel more empowered, where they have the dignity of ownership, and they feel they have a piece of the rock, as one employee owner put it to me. The employee owners are all equal, treated equally, and the benefits are as they should be, and so I applaud not only your leadership, from a policy standpoint, but your business leadership back home. Thank you very much. Thank you, and I yield back, Mr. Chairman.

Ms. COPHAM. Thank you. I very much appreciate your time, and if I can just add one last thing concerning the *Gross* legislation; that will also be very important because we would like to keep this in our family for years to come, and if valuation, if my dad happens to pass way, Heaven forbid, but if valuation is going to increase that tax burden by 40 percent, I don't know that we will be able to keep this in our family any longer. So, I appreciate the time.

Chairman MCCRERY. Sure. Thank you, Ms. Copham. We are going to have at least one vote, maybe a couple votes on the floor, three votes on the floor. Mr. Shaw, a Member of the Committee on Ways and Means is here. Ms. Copham, thank you very much.

Ms. COPHAM. Thank you. I appreciate it.

Chairman MCCRERY. I hope you make your plane all right. Mr. Shaw, a Member of the full Committee, is here and has done a lot of work on this subject. I am going to recognize him for a statement, and then we will probably let the representative from the Department of the Treasury do his oral statement, and then we will go vote. Mr. Shaw?

Mr. SHAW. Thank you, Mr. Chairman, I will be brief, and I do want to compliment Ms. Copham and her family for putting the right face on family owned businesses in this country. Businesses do care about their employees, and I think it is great testimony. We need, particularly where you have employee stock options or something, we really need to expand this subject or otherwise you can't do that.

By way of my statement, Mr. Chairman, I do want to thank you for allowing me to sit with you for these few moments this afternoon and allowing me to sit with you on the dais and consider my bill, the Subchapter S Modernization Act of 2003, and to other S corporation reform bills that will be before you.

As you know, I introduced this bipartisan bill with Mr. Matsui, Mr. McInnis, and Ms. Tubbs Jones as a comprehensive reform package for the over 2.5 million businesses today that pay taxes as S corporations, the vast majority of these being small businesses. The bill is targeted to those small businesses by improving their access to capital, preserving family-owned businesses, and lifting obsolete and burdensome restrictions that unnecessarily impede their growth. It will permit them to keep growing and competing into the 21st century.

Even after the relief provided in 1996, S corporations face substantial obstacles and limitations not imposed on other forms of entities. The rules governing S corporations need to be modernized to bring them more on par with the partnerships and C corporations.

For instance, the S corporations are unable to attract the senior equity capital needed for their survival and growth. The bill would remove this obsolete provision and also provide that S corporations can attract needed financing through convertible debt.

Additionally, the bill helps preserve family-owned businesses by counting all family members as one stockholder for purposes of S corporations—something that you will be very pleased with—for the purposes of S corporation eligibility. Also, nonresidents, aliens, would be permitted to be shareholders under the rules like those now applicable to partnerships. The bill would eradicate other outmoded provisions, many of which were enacted in 1958.

In addition, as a certified public accountant (CPA), I am working with the American Institute of Certified Public Accountants (AICPA) on legislation to enable startup S corporations to elect a fiscal year, rather than using the current calendar year to file taxes. I believe this bill, similar to the legislation introduced into the 104th Congress, will provide these new businesses the flexibility they need in their first year of business. I plan to introduce this bill again in the near future.

I am looking forward to hearing from the witnesses today and continuing to work with the Members of the Subcommittee on this most important matter. Again, Mr. Chairman, I thank you very much for allowing me to be part of your Subcommittee today.

Chairman MCCRERY. Yes, sir. Thank you very much, Mr. Shaw.

Our first witness on the listed and published list of witnesses will now testify before the Subcommittee. He is Greg Jenner, the Deputy Assistant Secretary for Tax Policy for the Department of the Treasury. Mr. Jenner, I understand you and your staff have done quite a bit of work on the S corporation issue, and we are looking forward to your testimony. If you could summarize it in about 5 minutes, that would be great.

STATEMENT OF GREGORY F. JENNER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. JENNER. I will do so. Thank you very much, Mr. Chairman, distinguished Members of the Subcommittee. My name is Greg Jenner, and I am the Deputy Assistant Secretary for Tax Policy of the Department of the Treasury. It is my pleasure to be here today.

There is little dispute that small businesses are the cornerstone of the American economy, and I can assure you the entire Administration, including the IRS and the Department of the Treasury, is committed to working with small businesses to help them understand their tax obligations, ease unnecessary restrictions, and reduce their compliance burdens.

Subchapter S is an important tool for small businesses. It was designed to provide them with a single layer of tax similar to that enjoyed by partnerships, while allowing them limited liability in corporate form. Major reforms in 1982 and 1996 eased many of the restrictions on S corporation eligibility. I won't go into the details of what those changes were.

These reforms, however, have enabled more businesses to operate as S corporations. Our statistics show that between 1982 and 2000, the percentage of nonfarm businesses taxed as S corporations rose from less than 4 percent to more than 11 percent. Although this trend is due, in part, to lowering of individual tax rates, the S corporation reforms certainly played an important role.

The S corporations, interestingly enough, are not the predominant form of entity used by small businesses, however. As of 1999, less than 8 percent of nonfarm businesses with gross receipts under $250,000 operated as S corporations. The vast bulk were sole proprietorships. We believe this is due to, in no small measure to the relative simplicity of operating as a sole proprietorship, rather than as a partnership or S corporation. I will get to that concern in a moment.

It also appears, interestingly enough, that S corporations are more attracted to large businesses than small businesses. More than 37 percent of nonfarm businesses with gross receipts over $1 million are S corporations, and more than 25 percent of nonfarm businesses with gross receipts over $50 million are S corporations.

The Administration has chosen to focus on broad-based tax initiatives that are not dependent upon organizational structure. We believe that tax should not play a significant role in the form in which a business chooses to operate. Thus, lowering income tax rates by 3 to 5 percentage points and increasing expensing from $25,000 to $100,000, as was just done, is far preferable, in our view.

Although these changes have provided much needed tax relief and simplification, complexity of the tax law continues to be a tremendous problem. Our laws have become devastatingly complicated in recent years. Many small business owners are unprepared to deal with this complexity and don't have the resources to hire sophisticated tax counsel, such as Mr. Alexander, to do so.

Tax compliance drains the time, energy and financial resources of small business owners and diverts their attention from the more important goals of building a business.

Subchapter S remains a simple, yet flexible, system in which small businesses can operate and thrive, and we hope to keep it that way. We recognize the importance of enhancing flexibility wherever and whenever possible. We also believe, however, that additional complexity is too high a price, in many instances, to pay for such flexibility.

I would point out that Subchapter S is no longer the only way that small businesses can obtain limited liability while paying only a single level of tax. The LLCs can now be taxed as partnerships and are a more flexible form of doing business than S corporations. That avenue is always open to them.

It is interesting to note that, in spite of this flexibility for LLCs, the number of S corporations grew faster than LLCs from 1996 to 2000. We believe that this is attributable directly to the complexity of the partnership system, compared with S corporations. Although S corporations have significantly more eligibility restrictions that don't apply to LLCs, these eligibility restrictions allow for a much simpler tax system for S corporations.

This should provide a cautionary note for all of us as we consider changes to S corporations. We should be very hesitant to support proposals that would move Subchapter S away from this paradigm, and we should always ask whether the proposed change would increase the complexity of Subchapter S and whether the tradeoff is worth it.

Our written testimony to date goes into the detail of the proposals that we support that are included in the three bills under consideration. Those proposals would provide solid technical reforms that are faithful to the goal that I have just outlined. They would decrease taxpayer burden, while offering increased flexibility.

Mr. Chairman, this concludes my prepared remarks. I would be more than happy to answer any questions.

[The prepared statement of Mr. Jenner follows:]

Statement of Gregory F. Jenner, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Mr. Chairman, Ranking Member McNulty, and distinguished Members of the Subcommittee:

I am pleased to appear before you today to discuss the various proposals to reform Subchapter S of the Internal Revenue Code.

The Benefits of Subchapter S

There is little dispute that small businesses are the cornerstone of the American economy. The millions of individuals who spend their time, energy, and resources pursuing ideas, taking risks, and creating value are instrumental to job creation and the growth of our economy. The entire Administration, including the IRS and the Department of the Treasury, is committed to working closely with the small business community and its representatives to help small businesses and the self-employed understand their tax obligations, ease unnecessary restrictions, and reduce their compliance burdens.

Subchapter S is an important tool for small businesses. Enacted in 1958, Subchapter S was designed to provide small businesses organized as state law corporations with a single-layer tax system similar to that enjoyed by partnerships. Major reforms in 1982 and 1996 moved the tax treatment of S corporations closer to that of partnerships while easing restrictions on S corporation eligibility. Among the 1996 reforms were: (1) increasing the number of S corporation shareholders from 35 to 75; (2) allowing S corporations to own subsidiaries; (3) allowing certain types of tax-exempt organizations and trusts to own S corporation stock; (4) allowing banks to elect S corporation status; (5) allowing an S corporation to create an employee stock ownership plan; (6) allowing the IRS to provide relief for late or invalid S corporation elections; and (7) exempting S corporations from the unified audit and litigation procedures.

The 1982 and 1996 reforms appear to have enabled a greater number of businesses to operate as S corporations. Between 1982 and 2000, the percentage of non-farm businesses taxed as S corporations rose from less than 4 percent to more than 11 percent. Although this trend is, in all likelihood, due in part to the significant lowering of individual tax rates, S corporation reforms certainly played an important role.

S corporations are not, however, the predominant form of entity used by small businesses. As of 2000, less than 8 percent of non-farm businesses with gross receipts under $250,000 were operating in S corporation form. The vast majority (79 percent) were operating as sole proprietorships, while the remaining 13 percent were operating as C corporations, partnerships, and limited liability companies taxed as partnerships. We believe that this is due in no small measure to the relative simplicity of operating as a sole proprietorship rather than as a partnership or S corporation.

Conversely, it also appears that the S corporation form is more attractive to larger business than to small businesses. More than 37 percent of non-farm businesses with gross receipts over $1 million are S corporations and more than 25 percent of non-farm businesses with gross receipts over $50 million are S corporations.

The relative attractiveness of S corporations will, in all likelihood, have diminished somewhat as a result of the recently-enacted Jobs and Growth bill. Doing business as an S corporation, for those businesses that qualified, offered the advantage of a single layer of tax at the shareholder level. In contrast, C corporations were taxed on their income at the corporate level, while their shareholders were taxed a second time on dividends distributed by the C corporation. By reducing the rate of tax on dividends to 15 percent, the Jobs and Growth bill has lessened (but not eliminated) the double tax on corporate income, thereby reducing (but again not eliminating) the tax advantage offered by S corporations.

Recognizing that small businesses may choose a variety of organizational forms, the Administration has chosen to focus on broad-based tax initiatives that are not dependent on organizational structure. It is our belief that tax should not play a significant role in the selection of the form in which a business chooses to operate. As a result, the President and Congress have worked together to reduce income tax rates by 3 to 5 percent and to increase the amount of investment that may be immediately deducted by small businesses from $25,000 to $100,000. In the 2001 Act, Congress phased out the death tax, allowing innovative entrepreneurs to pass the fruits of their lives' work to their children rather than the government. These changes will benefit 23 million small business owners, approximately 2 million of which are S corporations, providing cash for further investment and job creation. In addition, several regulatory changes have been made to ease the burdens on small businesses.[1]

Although these legislative and regulatory reforms have provided much needed tax relief and simplification to small businesses, the complexity of the tax laws continues to plague small business owners. Our tax laws have become devastatingly complex in recent years. Many small business owners are unprepared to deal with this complexity and do not have the resources to hire sophisticated tax counsel to advise them. Tax law compliance drains the time, energy, and financial resources of small business owners and diverts their attention from the more important goal of building a business.

It is our belief that Subchapter S remains a relatively simple, yet flexible, system in which small businesses can operate and thrive. We recognize the importance of enhancing its flexibility wherever and whenever possible. We are also concerned,

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[1] The Administration's efforts to decrease burdens on small business are not limited to legislative initiatives. For example, last year, the IRS and Treasury issued a revenue procedure permitting certain businesses with gross receipts of less than $10 million to use the cash method of accounting. We expect that the revenue procedure will eliminate most disputes concerning the use of the cash method by small business taxpayers, allowing those taxpayers to focus on growth, not tax compliance. Other recently implemented burden reduction projects benefiting small businesses include:

1. Exempting 2.6 million small corporations from filing Schedules L, M–1 & M–2, reducing burden by 61 million hours annually. (April 2002)
2. Reducing the number of lines on Schedules D, Forms 1040 and 1041, resulting in estimated burden reduction of 9.5 million hours for 22.4 million taxpayers. (January 2002)
3. Eliminating the requirement for filing Part III of Schedule D (capital gains), Form 1120S for 221,000 S-Corporation taxpayers, reducing burden by almost 600,000 hours. (November 2002)

The IRS has also streamlined many of its procedures to make compliance less burdensome for small business taxpayers. A few examples include:

1. The establishment of a permanent special group to work with payroll services to resolve problems before notices are issued and penalties are assessed against the individual small businesses serviced by these bulk and batch filers. (October 2002)
2. Business filers can now e-file employment tax and fiduciary tax returns, and at the same time, pay the balance due electronically by authorizing an electronic funds withdrawal.
3. Business preparers can now e-file their clients' employment tax returns.
4. The IRS has continued to improve its Web site to offer its customers the ability to both order, and in many cases, utilize its Small Business Products online.

It is the long-term and continuing goal of the IRS and the Treasury to ease the burden of small businesses to the greatest extent practical, consistent with the law as enacted by Congress. We look forward to working with this committee on those efforts.

however, that such flexibility should not be achieved at the cost of greater complexity. As a result, we analyze proposed changes to Subchapter S by asking whether the proposal would increase the complexity of Subchapter S and, if so, is such increased complexity more than offset by the benefits of the proposed change.

It is important to remember that Subchapter S is no longer the only way small businesses can achieve limited liability while paying only a single layer of tax. As a result of regulations issued in 1995, state law limited liability companies can now be taxed as partnerships. Many practitioners now tout the benefits of the more flexible limited liability company entity over the more restrictive S corporation entity.

Interestingly, however, between 1996 and 2000, growth in the number of S corporations has exceeded growth in the number of limited liability companies taxed as partnerships. We believe this is due in no small measure to the complexity of the partnership system compared with S corporations. Although S corporations must meet eligibility restrictions that do not apply to limited liability companies, these eligibility restrictions allow for a much simpler system of taxing S corporation income. In particular, the inordinately complex systems for determining a partner's shares of partnership income do not apply to S corporations. In short, despite eligibility restrictions, an S corporation is perhaps the only organizational form available to small multi-member businesses that offers relative simplicity. Consequently, we hesitate to support proposals that would add additional complexity to Subchapter S.

H.R. 714, H.R. 1498, and H.R. 1896

Because of the large number of proposals included in the bills under consideration today, our testimony does not set out Treasury's views on each provision. Instead, our testimony identifies the provisions that the Administration would not oppose on substance, and sets out our views on those provisions. To reiterate, our basic goal is to preserve the relative simplicity of Subchapter S while offering additional flexibility to businesses taxed as S corporations. We believe that these provisions are either consistent with, or not contrary to, that basic goal. We would also point out the need to exercise fiscal discipline in considering additional tax measures, and that any tax bill inclusive of these or other tax provisions should not increase the deficit further.

Allow shareholders of an S corporation to obtain the full benefit of a charitable contribution of appreciated property by the corporation (Section 11 of H.R. 714 and section 205 of H.R. 1896). In cases where an S Corporation donates appreciated property to charity, a shareholder's basis in their S corporation stock reflects the basis of that appreciated property, whereas the amount contributed is the fair market value of the appreciated property. Under current law, an S corporation shareholder's charitable deduction is limited to his or her stock basis. As a result, current law prevents some S corporation shareholders from obtaining the full benefit of the charitable contribution deduction. The proposal would allow an S corporation shareholder to increase the basis of their S corporation stock by the difference between the shareholder's share of the charitable contribution deduction and the shareholder's share of the basis of the appreciated property. This treatment is already provided to partnerships and limited liability companies. Therefore, this proposal would accomplish the twin goals of encouraging charitable giving and equalizing the treatment of S corporations and partnerships.

Permit a bank corporation's eligible shareholders to include an IRA and allow shares held in an IRA to be purchased by the IRA owner (Section 103 of H.R. 1896). A corporation cannot elect S corporation status if its stock is held by an IRA, and income of an S corporation that is allocable to a tax-exempt entity generally is treated as unrelated business taxable income. The only exception is for employee stock ownership plans (ESOPs) which are themselves subject to special strict rules mandated by EGTRRA. In addition, an IRA owner cannot purchase assets held by the IRA without a special exemption. The proposal would permit an IRA to be a permissible shareholder of a bank S corporation. In addition, an IRA owner would be permitted to purchase S corporation shares held by the IRA without the need for a special exemption. These changes would only apply to shares held prior to enactment of the provision. This proposal would result in some additional complexity that it would be preferable to avoid. However, on balance, we believe that this complexity is outweighed by the flexibility that would be provided to IRAs currently owning bank shares. Our support, however, is explicitly conditioned on the S Corporation income earned in the IRA being treated as unrelated business taxable income. We are concerned that, if enacted, subsequent efforts will be made that would make such income not subject to UBIT (as was done in the case of ESOPs), thus eliminating any and all tax on such income.

Allow S corporation shareholders to transfer suspended losses on a divorce (Section 302 of H.R. 1896). Under current law, losses that exceed the shareholder's basis in S corporation stock are suspended and may be carried over indefinitely and used when the shareholder acquires sufficient basis in the S corporation stock. The losses, though, cannot be transferred to another person. If, as a result of a divorce, a shareholder must transfer S corporation stock to his or her former spouse, the suspended losses associated with that stock are lost. Section 302 would remedy this unduly harsh result by allowing suspended losses to be transferred along with the S corporation stock transferred incident to divorce.

Allow beneficiaries of qualified subchapter S trusts (QSSTs) to use passive activity losses and at-risk amounts (Section 303 of H.R. 1896). Generally, the current income beneficiary of a QSST is taxed on S corporation income. Losses that flow through to the beneficiary from the S corporation may be limited under the passive activity loss or at risk rules. For most S corporation shareholders, losses that are limited under the passive activity loss or at risk rules carry over until the shareholder disposes of the activity generating the passive loss or at risk amount. At that time, the shareholder may take any remaining suspended passive activity and at-risk losses. Unfortunately, the S corporation rules provide that the QSST and not the income beneficiary is treated as the owner of the S corporation stock for purposes of determining the tax consequences of a disposition of the S corporation stock. Because the beneficiary is treated as the owner of the S corporation stock for income reporting purposes, but not for purposes of gain or loss on the disposition of S corporation stock, it is unclear whether losses flowing through to a QSST beneficiary that are suspended under the passive activity loss or at risk rules may be used on the disposition of the S corporation stock. This proposal would clarify that, for purposes of applying the passive activity loss and at risk rules, the disposition of S corporation stock by a QSST will be treated as the disposition of the stock by the income beneficiary of the QSST.

Permit an electing small business trust (ESBT) to claim an income tax deduction for any interest incurred to purchase S stock (Section 304 of H.R. 1896). This proposal would eliminate an existing distinction between an individual purchaser of S corporation stock and a trust purchaser, and would make the ESBT more attractive. Under current law, the only permissible deductions against an ESBT's income are its administrative expenses, such as costs incurred in the management and preservation of the trust's assets; interest incurred to acquire S corporation stock is not deductible. Treasury does not oppose this proposal, but we believe that the interest deduction should be no more generous to an ESBT purchaser of S corporation stock than the interest deduction available to an individual purchaser of that stock. We would be pleased to work with the Subcommittee to achieve that result.

Disregard unexercised powers of appointment in determining the potential current beneficiaries of an ESBT (Section 305 of H.R. 1896). This proposal would significantly improve the ESBT rules by removing a technical impediment that currently prevents many trusts from making the ESBT election. Many existing trusts grant to an individual the ability to name additional persons and entities as trust beneficiaries (for example, as substitute beneficiaries in the event of the death of a current beneficiary, or a change in circumstances that renders a current beneficiary "unworthy" of receiving benefits from the trust). Usually, the group of permissible appointees is described as an identified class of persons or entities, such as the descendants of the grantor's grandparents or any charitable organizations. Such a class of permissible appointees has an almost unlimited number of members. Current law limits the number of shareholders of an S corporation to 75, and all of the members of the class of potential appointees count toward that 75-person limit. As a result, if an ESBT election is made for a trust that grants such a power of appointment, the S election of the corporation will be terminated, even though that power of appointment may never be exercised. This proposal would disregard such powers so long as they were not exercised.

Allow the S corporation's charitable contributions to be deducted from its gross income (Section 307 of H.R. 1896). Under current law, an individual S corporation shareholder may claim an income tax charitable deduction for his or her share of a charitable contribution made by the S corporation. However, because of the rules regarding charitable deductions of trusts, a shareholder whose S corporation stock is held in a trust will receive no comparable tax benefit from that contribution. Section 307 would explicitly add charitable contributions to the items that can be deducted in computing the ESBT's income tax on its S corporation income. This proposal would encourage charitable giving by S corporations and would eliminate a significant difference in the tax treatment of an S corporation's individual and non-individual shareholders. We suggest that this Subcommittee consider expanding the application of this provision to other pass-through entities making charitable contributions. This could be accomplished by amending the trust rules to provide that trusts may deduct charitable contributions made by all types of pass-through entities in a way that is comparable to the charitable deduction available to individuals (and subject to the same limitations).

Allow banks to exclude investment securities income from passive investment income (Section 3 of H.R. 714 and section 401 of H.R. 1896). S corporations with accumulated C corporation earnings and profits are subject to a corporate-level tax on passive investment income that exceeds 25 percent of the corporation's gross receipts for any year. Additionally, a corporation's S corporation status is terminated if the 25 percent limit is exceeded for three consecutive years. Gross receipts derived in the ordinary course of a banking business are not considered passive investment income for this purpose. Income from investment assets, however, is treated as derived in the ordinary course of a banking business only if the investment assets are needed for liquidity or loan demand. The amount of investment assets needed for liquidity or loan demand may be subject to disagreement. This provision would eliminate this uncertainty by providing that passive investment income would not include any interest income earned by a bank, bank holding company, or qualified subchapter S subsidiary (in the case of H.R. 1896 only) or dividends on assets required to be held by such bank, bank holding company, or qualified subchapter S subsidiary (in the case of H.R. 1896 only) to conduct a banking business. We recommend that this proposal be clarified to apply only to a bank, bank holding company, or a qualified subchapter S subsidiary *of a bank or a bank holding company*.

Allow a bank to recapture its bad debt reserves on either its first S corporation or its last C corporation return (Section 6 of H.R. 714 and section 403 of H.R. 1896). Under current law, banks that use the reserve method of accounting are ineligible to make the S corporation election. If a bank makes an S corporation election, the bank is automatically switched to the specific charge-off method of accounting for bad debts. This change in accounting method results in recapture of the bad debt reserve over four years. The recapture of the reserve by the bank S corporation is treated as built-in gain subject to a special corporate-level tax. Under the built-in gain provisions, tax on the built-in gain must be paid both at the corporate and shareholder level in the year of recognition. In contrast, a C corporation would pay tax on the recapture amount at the corporate level but the shareholders would not have to pay tax on that amount until the C corporation paid dividends. By allowing banks to take the recapture of the bad debt reserves into account in the last C corporation year, rather than the first S corporation year, the proposal would eliminate the current imposition of a second layer of tax. This provision is similar to a provision of the Code designed to recapture LIFO reserves on the conversion of a C corporation to an S corporation. Under that provision, the LIFO recapture amount is taken into account in the year before the conversion to S corporation status, but the corporation is allowed to pay the tax on the recapture amount over 4 years. We recommend that similar principles be applied to address the recapture of bad debt reserves and would be happy to work with this Subcommittee to draft an appropriate provision.

Allow the IRS to provide relief for inadvertently invalid qualified Subchapter S subsidiary (QSub) elections and terminations (Section 501 of H.R. 1896). Section 1362(f) authorizes the Secretary to provide relief for inadvertent invalid S corporation elections and inadvertent terminations of S corporation elections. This provision has saved hundreds of taxpayers from the consequence of procedural mistakes; invalid elections and inadvertent terminations are common because S corporations and their shareholders are often unfamiliar with the technical requirements of eligibility. Under current law, however, there is no comparable relief available for QSubs. Allowing the Secretary to grant relief for inadvertent invalid QSub elections and terminations would prevent shareholders from suffering significant negative consequences for mere procedural errors.

Provide that a sale of an interest in a QSub is treated as a sale of a pro rata share of the QSub's assets, followed by a contribution of those assets to a corporation (Section 503 of H.R. 1896). A QSub must be wholly owned by a single S corporation. Under current law, if an S corporation sells more than 20 percent of the stock of a QSub, the S corporation will recognize gain and loss on all of the assets of the QSub. The proposal would change this to align the treatment of the sale of an interest in a QSub with the treatment of the sale an interest in a limited liability company that is treated as a disregarded entity.

Eliminate the earnings and profits earned by a corporation as an S corporation prior to 1983 (Section 601 of H.R. 1896). Prior to 1983, income earned by an S corporation gave rise to earnings and profits. Concluding that it was inconsistent with the modern view of S corporations to continue to view pre-1983 S corporation income as giving rise to earnings and profits, in 1996 Congress eliminated pre-1983 earnings and profits for any corporation that was an S corporation prior to 1983, but only if the corporation was an S corporation in its first taxable year beginning after December 31, 1996. Section 601 would eliminate pre-1983 earnings and profits arising during an S corporation year, regardless of whether the corporation was an S corporation in its first taxable year beginning after December 31, 1996. In our view, relief from pre-1983 S corporation earnings and profits should not be dependent on whether the corporation continued to be an S corporation after 1996.

Allow charitable contribution carryforwards and foreign tax credit carryforwards to offset the corporate-level tax on built-in gains (Section 603 of H.R. 1896). Under current law, an S corporation may use net operating loss carryforwards and capital loss carryforwards to offset the tax on built-in gains under section 1374. It is our view that charitable contribution carryforwards and foreign tax credit carryforwards should also be available to offset section 1374 built-in gains.

Expand the number of permissible S Corporation shareholders (Section 4 of H.R. 714 and section 104 of H.R. 1896). These proposals would increase the number of permissible S Corporation shareholders from 75 to 150. Treasury cannot support such a dramatic increase, which we believe would run counter to the goal of maintaining Subchapter S as the simplest of systems for businesses with more than one owner. Increasing the number of shareholders will, inevitably, bring increased pressure to liberalize other facets of Subchapter S which will, in turn, increase the complexity of the provisions. It is important to keep in mind that the number of permissible shareholders was more than doubled, from 35 to 75, just a few years ago. For these reasons, we urge this Subcommittee to refrain from dramatic expansion of these rules.

* * *

We believe that the proposals outlined here could provide solid technical reforms that would be faithful to the spirit of subchapter S. Consistent with the goal of subchapter S to provide simple rules for small business, these rules would decrease taxpayer burden, while offering increased flexibility. We would be pleased to work with the Committee to develop these or other S corporation reform proposals.

This concludes my prepared statement. I would be pleased to answer any questions the Subcommittee may have.

Chairman MCCRERY. Thank you, Mr. Jenner. I am going to recess the hearing so that the Members can go vote, and when we return, we will allow the Members to ask questions of you.

Mr. JENNER. Thank you very much.

Chairman MCCRERY. The hearing is in recess.

[Recess.]

Chairman MCCRERY. The hearing will come to order. We have been advised by the Democratic staff that we may proceed, and they will not object. So, we shall proceed and hope that they do not object. So, Mr. Jenner, I have a series of questions I would like to put to you, and then if one of my Democratic colleagues shows up, certainly give him or her the opportunity to do the same.

In 1996, Congress allowed, for the first time, banks to elect S corporation status. However, many small community banks are prevented from converting to S corporations because their employees hold bank shares in their individual retirement accounts (IRAs). Mr. Shaw's bill and Mr. McInnis' bill would allow two forms of relief for this situation.

Number one, they would waive the prohibited transaction rules which prevent IRAs from selling shares to the holder of the IRA; and, number two, their bills would allow IRAs to hold S corporation stock if the IRA paid unrelated business income tax on income flowing from the bank. I understand, from talking with some of the bankers, that this is important because some of the holders of the IRAs may not have the cash to buy the shares from the IRA.

What is the Department of the Treasury's views on these provisions?

Mr. JENNER. Mr. Chairman, we are generally supportive of the provisions. We would be concerned if the shares that were sold were not sold at fair-market value, and we think that we can address that concern.

The other cautionary note that we would raise is any subsequent effort to eliminate the unrelated business income tax. We note that there was a proposal, very similar, done a few years ago relating to ESOPs, where originally the unrelated business income tax was imposed and was later repealed, and we would urge you, if you are going to do this, to make sure that the unrelated business income tax stays in place for shares held by IRAs.

Chairman MCCRERY. Now, our first witness today representing the S-Corp talked about a recent decision in the Sixth Circuit, the *Gross* decision, which changed the stock valuation rules for S corporations. Can you give us the Department of the Treasury's view on this case.

Mr. JENNER. Yes, Mr. Chairman. The facts of the *Gross* case were that the tax court, and later the Sixth Circuit, basically weighed in on a battle of expert opinions between the IRS and the taxpayer. It was a very fact-specific opinion. While there is some precedential value to it, again, all valuations are very fact specific. So, with all due respect to the previous witness, we would argue that there is not a serious concern with respect to the *Gross* opinion, and it may very well never apply in particular fact situations.

Chairman MCCRERY. Witnesses on the next panel will testify that Mr. Ramstad's bill has anti-abuse rules to prevent C corporations from converting to Subchapter S merely to avoid the built-in gains taxes. Have you reviewed the Ramstad view, and do you have a view on the efficacy of these anti-abuse rules?

Mr. JENNER. We have reviewed the bill, Mr. Chairman. We have serious reservations about Mr. Ramstad's bill, notwithstanding the fact that efforts have been made to place anti-abuse rules. One of the difficulties, of course, is that cash is cash, and even though you can say that you can't use the cash for certain reasons, if the corporation has other cash that can be used for that very reason, then it doesn't matter which pool of cash you are drawing from.

We also think that providing a limited window of opportunity to eliminate the built-in gains tax is unfair. It is similar, I hate to use the word "amnesty," but it is a temporary relief provision, and we have very great concerns about opening a window of opportunity and then closing it again.

Chairman MCCRERY. Also, on the next panel, the National Cattlemen's Beef Association (NCBA) expresses a desire for a one-time election for an S corporation to convert to a LLC status. What is your view on that proposal?

Mr. JENNER. Again, Mr. Chairman, we have serious reservations about that. We think that there is a substantial possibility of abuse, as well as the elimination of tax that should be paid if, as a result, the S corporation was originally a C corporation, and you have the built-in gains tax. There are real serious concerns with the proposals.

Chairman MCCRERY. If we want banks to become S corporations, why do we enforce a one-class-of-stock-only rule because, as you know, banks often have director's shares. They are required to under the regulations, and so if we want them to convert or if we want to give them the opportunity to convert, why would we insist on this one-class-of-stock-only rule?

Mr. JENNER. Well, we are concerned that if you allow director's shares, there is a potential for abuse and manipulation, that the amounts paid on account of director's shares would be treated as debt. It would be income to the recipient, but again it is uncontrolled by any sort of equal allocation rule with other shareholders.

We do understand the Office of the Comptroller of the Currency (OCC) has said that such requirements should be in place. What I suggested to your staff is that we would be happy to sit down with our colleagues at the OCC to see whether or not we can come up with a creative solution that perhaps alleviated the requirement of director's shares and, thus, didn't implicate the tax system at all, and we will do that.

Chairman MCCRERY. Yes. It seems to me that there ought to be a way to skin this cat. So, I would urge you to do as you suggested and figure out a way to make it work.

Mr. JENNER. We will do that, Mr. Chairman.

Chairman MCCRERY. You noted that the passage of the growth bill by Congress, which reduces the double tax of the earnings of C corporations, makes S corporations relatively less attractive than they were before, from a tax standpoint. Has the Department of the Treasury done any research or seen any evidence suggesting how much this will change businesses' decisionmaking between the corporate structures?

Mr. JENNER. We have not done any specific research, and we think it is a little early to tell yet. There is no question that the relative advantage has been reduced, but there are a lot of advantages that flowed from the S corporation form of doing business that are not necessarily tax related, and therefore it is unclear whether there is going to be a dramatic shift.

Chairman MCCRERY. You said in your testimony that there were a number of reforms in the bills that we were looking at in this Subcommittee that the Department of the Treasury thought were appropriate. Could you just tick off a few of them for us?

Mr. JENNER. Certainly. I can begin at the beginning of my testimony:

- Allowing shareholders of an S corporation to obtain the full benefits of a charitable contribution of appreciated property;
- As we mentioned before, allowing IRAs to hold bank shares;
- Allowing S corporations to transfer suspended losses on a divorce;
- Allowing beneficiaries of qualified Subchapter S trusts to use passive activity losses in that risk amounts;
- Permitting and electing small business trusts (ESBT) to claim an income tax deduction for interest used to purchase S corporation stock;
- Disregarding unexercised powers of appointment in determining potential beneficiaries of an ESBT;

- Allowing an S corporation's charitable contribution to be deducted from its gross income;
- Allowing banks to exclude investment securities income from passive investment income;
- Allowing a bank to recapture its bad debt reserves on either its first S corporation year or its last C corporation year;
- Allowing the IRS to provide relief for inadvertent and valid qualified S corporation subsidiary (QSub) elections and terminations;
- Providing that a sale of an interest in a QSub is treated as a sale of a pro rata share of the QSub's assets;
- Eliminating the earnings and profits earned by a corporation as an S corporation prior to 1983;
- Allowing corporation contribution carry-forwards and charitable contribution carry-forwards and foreign tax carry-forwards to offset corporate-level tax on built-in gains;
- And, in certain circumstances, expanding the number of permissible S corporation shareholders.

Chairman MCCRERY. What about the proposals to allow multiple generations of a family to be one shareholder?

Mr. JENNER. I am afraid we have some serious reservations about that proposal. Ironically, I actually worked on it when I was in private practice. It has some serious complexity and administratability issues that we think cannot be overcome. Plus, I think that there are probably ways to deal with it.

Chairman MCCRERY. So, your preferred approach to solving the problem would be to increase the number of allowable shareholders, generally.

Mr. JENNER. To a certain point. We are concerned about a dramatic increase. Again, as I indicated in my verbal testimony, one of the things that we are trying to do is preserve S corporations, the paradigm of Subchapter S, which is small business and a small number of owners, and we think we are concerned about expanding the number of shareholders to too large an amount.

Chairman MCCRERY. Thank you very much. Ms. Tubbs Jones, would you like to inquire of Mr. Jenner?

Ms. TUBBS JONES. You were hoping I wasn't coming back so you could run out of here.

Mr. JENNER. That is absolutely not true.

[Laughter.]

Ms. TUBBS JONES. Thanks, I won't be long. What happens if when, in an S corporation, the prior witness said that she was worried about the estate tax problems for her and her brother, what happens when her father dies? I am not trying to say he is getting ready to die, so nobody should take that out of here, but if her father dies?

Mr. JENNER. If the father owns the S corporation stock, which I assume he does, that stock will be included in his estate for estate tax purposes, and depending upon whether or not the estate is valued at more than the unified credit amount, plus an additional amount for small business, that excess could be taxed. Again, it depends on valuation, and the concern that the previous witness was raising was one about valuation—how do you actually value closely held businesses—and she was concerned about this court case.

Ms. TUBBS JONES. You are here from the Department of the Treasury, but I am assuming you are a tax lawyer; is that a fair statement?

Mr. JENNER. Unfortunately, yes, it is, ma'am.

Ms. TUBBS JONES. Wait a minute. I am a lawyer. I am not a lawyer basher. I love lawyers.

[Laughter.]

Mr. JENNER. No, but a tax lawyer, we get a lot of kidding.

Ms. TUBBS JONES. They all love lawyers when they need one, though, so that is the way we have to look at it, that perspective.

Mr. JENNER. That is true.

Ms. TUBBS JONES. Is there an advantage, from your perspective, of being an S corporation versus the more flexible LLC—and you might have answered this before I came in. If you did, I apologize—LLC structure or weigh them for me and tell me, in 2 minutes or less, the advantage of one over the other.

Mr. JENNER. I am going to sound like an economist. It depends.

Ms. TUBBS JONES. Uh-huh, Alan Greenspan. Go ahead.

[Laughter.]

Mr. JENNER. The S corporations provide a relatively simple system of taxation. On the other hand, eligibility for S corporation status is more restricted. If you can qualify for S corporation status, you are probably better off, if you want a simple system. The LLCs are taxed as partnerships, and I remember one of my tax professors at New York University (NYU), which is a premier tax school in the country, saying——

Ms. TUBBS JONES. I like Case Western Reserve, personally, but go ahead.

[Laughter.]

Mr. JENNER. It is a great school, no question about it. This professor was saying that he never understood partnership tax, and if one of the professors at NYU doesn't understand it, it is complicated. It is very, very complicated.

Ms. TUBBS JONES. What have you, in your experience, are S corporations more "mom and pop" type of operations or do they also include, well, in small business we talk about a dollar value in order to qualify as a small business? What about S corporations?

Mr. JENNER. Well, they run the gamut. Many of them are small, but you tend to see some pretty big ones too. Some statistics, from one of my colleagues, there are 2 out of every 1,000 that have 20 or more shareholders. So, that means 5,000 out of 2.8 million S corporations have more than 20 shareholders. Many of them tend to be small, but I can tell you from private practice experience that there are some really big ones, too, and I probably can name them if you ask me, name some of them. They are huge.

Ms. TUBBS JONES. I won't put you through that.

Mr. JENNER. Thank you.

Ms. TUBBS JONES. Mr. Chairman, I am going to yield back the balance of my time, in the name of us getting out of here.

[Laughter.]

Chairman MCCRERY. Thank you, Mr. Jenner, very much for your testimony and for your patience as we complete our duties on the floor. We look forward to having you back at a later date for further discussion of a most interesting topic.

Mr. JENNER. Thank you very much, Mr. Chairman, Ms. Tubbs Jones.

Ms. TUBBS JONES. I have to say, Mr. Jenner, it is not often that I get to be Ranking Member, and this is my first time on the Committee on Ways and Means. So, I have to take advantage of making a record of it.

Mr. JENNER. Well, I am privileged to be a part of it.

[Laughter.]

Chairman MCCRERY. There you go. At this time, I would call the second, and last panel of the hearing. Hon. Donald C. Alexander, on behalf of the U.S. Chamber of Commerce; Mr. Robert A. Zarzar; Laura M. MacDonough; Rusty Cloutier, President and chief executive officer, MidSouth Bank, Lafayette, Louisiana; and David True, Owner of True Ranches in Casper, Wyoming, on behalf of the NCBA.

I should have said Mr. Cloutier is here on behalf of the Independent Community Bankers of America (ICBA). Ms. MacDonough is here as a Member of the S Corporation Taxation Technical Resource Panel, and Mr. Zarzar is here on behalf of or as a Member of the Tax Executive Committee of the AICPA. So, we have a very distinguished panel, and we look forward to hearing your testimony.

Now, before I begin with Mr. Alexander, I would like to welcome my Louisiana neighbor from down South, as you might guess from his name, Mr. Cloutier, spelled C-l-o-u-t-i-e-r. He is not from Shreveport. He is from Lafayette, Louisiana and a distinguished banker in his community. He is also a very civic-minded individual who has helped me with some statewide projects that we both hope will come to fruition to improve economic conditions in our State. So, welcome, Mr. Cloutier.

Mr. CLOUTIER. Thank you very much, Congressman.

Chairman MCCRERY. We will begin with the Honorable Donald C. Alexander. Welcome.

STATEMENT OF THE HONORABLE DONALD C. ALEXANDER, AKIN, GUMP, STRAUSS, HAUER, & FELD, LLP, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. ALEXANDER. Thank you, Mr. Chairman, and thank you, Ranking Member. I am glad to be here to talk with you about Subchapter S. I request that my statement be entered into the record because I am not going to read it.

Chairman MCCRERY. Without objection.

Mr. ALEXANDER. It was interesting to hear the Department of the Treasury testify and to read their statement. They are quite concerned about complexity, and they want to eradicate complexity by keeping the Subchapter S rules as rigid as they are today, with some exceptions that the Deputy Assistant Secretary spelled out to you, Mr. Chairman.

I don't think that works very well. You have an overly rigid law, and Subchapter S, enacted 45 years ago in 1958, has now outlived some of the requirements that the Deputy Assistant Secretary was discussing. The Assistant Secretary, before she became Assistant

Secretary, made a statement that I think is worth considering. She said the repeal of many of the restrictions in Subchapter S, one class of stock, a small number of stockholders and the like, would simplify the law, rather than make the law more complex.

Now, in my statement, I have a couple of examples of just that. If a law is too rigid, rigidity does not promote simplicity because people have to find a way, due to business needs, to try to get around the rigidity of the written law, and that is exactly what happened in a couple of instances involving the limitation on the number of stockholders and involving preferred stock.

In the partnership regulations, there is a provision that says it is fine for a Subchapter S corporation to set up a partnership with a nonresident alien stockholder or, let us say, the 76th stockholder. That is great. You can do that. You can do it through the back door, not the front door.

If it is so easy, according to the Department of the Treasury at least, to get around the restriction, why have the restriction in the first place? Well, the reason that it is there in the first place is that it is not easy. Somebody has to know about that partnership regulation provision, somebody has to advise how to use it, and somebody has to advise using two vehicles to serve the place of one.

Second, preferred stock. There is a way, according to a Department of the Treasury official, to get around the prohibition against the use of mezzanine capital. Preferred stock is a great way to attract capital into a small business, and you look to your stockholders for additional capital without diluting the voting and economic interests of the other common stockholders, generally, the second generation.

You can do it if you are willing to drop some entity below the Subchapter S corporation and divide that entity between preferred interests going to the people that would be preferred stockholders and the Subchapter S corporation, consisting of a limited number of common stockholders.

So, we have vast complexity, but we just don't have it in the Subchapter S provisions of the Internal Revenue Code. We have it in the operation of those provisions. To me, that makes no sense. To me, the Shaw bill, the McInnis bill, and I am also in favor of the Ramstad bill, although it is more limited in its scope, would permit Subchapter S to be a truly competitive vehicle for the carrying on of small, and independent and family businesses without the shackles that we now have and without having to jump through hoops to get around those shackles. Thank you.

[The prepared statement of Mr. Alexander follows:]

Statement of the Honorable Donald C. Alexander, Akin, Gump, Strauss, Hauer, & Feld, LLP, on behalf of the U.S. Chamber of Commerce

I am appearing this morning on behalf of the U.S. Chamber of Commerce ("the Chamber") to discuss S Corporation reform. The United States Chamber of Commerce is the world's largest business federation representing more than three million businesses and organizations of every size, sector and region, with substantial membership in all 50 states.

My topic is the need for reform and simplification of the restrictive rules, enacted 45 years ago, that still shackle the more than 2,500,000 Subchapter S corporations in the United States. While a number of constructive changes were made in 1996, much remains to be done to permit family-owned businesses to utilize an entity that provides limited liability and passes income through the entity to its owners.

The massive changes that have recently been made in the taxation of business income call for reconsideration of the rigid rules governing Subchapter S taxpayers. The huge reduction in the rate of tax on dividend income means that the tax imposed on C corporations and that transmission of income (whether or not subjected to corporate tax) to the stockholders is now much lower than it was last year. The tax imposed on the owner of a pass-through business entity, whether Subchapter S, Subchapter K or a sole proprietorship, has been reduced only slightly thanks to acceleration of phased-in rate reductions. Therefore, the perceived advantage of conducting a business through an entity which passes through its income to its owners for tax purposes has been reduced, and the fact of this reduction should not be disregarded in determining whether restrictions imposed in an entirely different tax world should be lifted today.

Years ago Subchapter S corporations were the entity of choice if the owner of a small business wished to obtain the benefits of operating through the corporate form (limited liability) without suffering the detriment of double taxation on the business's earnings. However, after the Treasury's blessing of the limited liability company, plus the Treasury's adoption of check-the-box rules, partnership tax treatment (correctly called "tax nirvana") has been conferred upon entities that were not formerly treated as partnerships. Limited liability companies are clearly preferable to Subchapter S corporations from the Federal tax standpoint; examples of favored treatment are the partnership basis rules (partner's basis includes partnership debt) and liberal rules permitting disproportionate allocation of income and loss among partners. It is no wonder the recent wave of aggressive tax shelters typically used a partnership as the vehicle to transfer tax benefits. But some entities, like banks, must conduct their businesses in corporate form and others are required to do so by state laws or other rules. They must use Subchapter S. Moreover, many Subchapter S corporations are locked in to elections made years ago; while they would prefer to adopt the tax-favored partnership form, they cannot without a heavy tax toll charge. Subchapter S corporations are found on Main Street, not Wall Street. They are not asking for the famous "level playing field", *i.e.*, the favored tax treatment granted to partnerships. Instead, they are simply asking that some of the fetters imposed in another era be removed.

Treasury officials have not been responsive to the proponents of Subchapter S reform. Among the reasons for opposition is the notion that while it is fine for partnerships to seek and obtain tax advantages through a sea of complexity, Subchapter S must be kept simple for simple people. By confusing rigidity with simplicity, this notion creates complexity. Examples are the rules prohibiting a nonresident alien from being a stockholder in a Subchapter S corporation and limiting the number of Subchapter S stockholders. Example 2 of Reg. § 1.701–2(d) shows that a nonresident alien (or the 76th stockholder) can participate in a Subchapter S corporation's business by becoming a partner with the Subchapter S corporation. A further example deals with preferred stock. A Treasury official suggested that a Subchapter S corporation could create the equivalent of preferred stock by dropping assets into a limited liability corporation that would issue a preferred-like interest to preferred holders. Why require these complex maneuvers? Why not permit the nonresident alien, or the 76th stockholder, or the preferred stockholder, to come through the front door?

When she testified for the American Bar Association Tax Section before the House Committee on Small Business on the impact of the Code's complexity, now Assistant Secretary Pamela Olson said:

> The definition of an "S corporation" contained in section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than seventy-five shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of Federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.

The Impact of Complexity in the Tax Code on Small Businesses: Hearing Before the House Subcomm. on Tax, Fin. and Exp. of the Comm. on Small Bus., 106th Cong. (statement of Pamela F. Olson).

Ms. Olson was right. S corporations are indeed disadvantaged, these restrictions are extremely complex, and their removal would greatly simplify the law for Main Street businesses.

These simplifications should include, at least, the following:

1. S corporations should have access to senior equity by the issuance of preferred stock, as well as bank directors' qualifying shares. Payments to owners of such stock or shares should be treated as an expense to the S corporation and ordinary income to the shareholders.
2. The number of S corporation eligible shareholders should be increased from 75 to 150, thus helping community banks to broaden their ownership and Subchapter S corporations to provide equity to key employees. Members of a family should be treated as one stockholder, as they are for other purposes of the Code.
3. Capital gains should be excluded from classification as passive income. Long term capital gains would be subject to a maximum 15 percent rate at the shareholder level, thus conforming to the general treatment of such gains as well as their treatment under the personal holding company rules.
4. The restrictive rules on excess passive income should be modified as recommended by Joint Committee on Taxation Staff, and interest and dividends on investments maintained by a bank for liquidity and safety and soundness purposes should not be treated as passive income.
5. Nonresident aliens should be permitted to own Subchapter S stock, subject to the limitations applicable to partnerships.
6. Subchapter S corporations should be permitted to issue convertible debt.

Most of the improvements listed above are contained in Representative Shaw's bill, H.R. 1896. As Representative Shaw stated on introduction of a similar bill:

> Today over two million businesses pay taxes as S corporations and the vast majority of these are small businesses. The Subchapter S Revision Act of 1999 is targeted to these small businesses by improving their access to capital preserving family-owned businesses, and lifting obsolete and burdensome restrictions that unnecessarily impede their growth. It will permit them to grow and compete in the next century.

Cong. Rec. E196 (Feb. 10, 1999) (statement of Rep. Shaw).

As I understand it, three bills reforming and revising Subchapter S are now before this Subcommittee for consideration. The most comprehensive is H.R. 1896, proposed by Mr. Shaw, which would make a number of needed changes, including an increase in the number of permitted stockholders, treating family members as one stockholder, and permitting the issuance of preferred stock. Mr. McInnis' bill, H.R. 714, contains many similar provisions. Both would assist banks to operate as Subchapter S corporations. Mr. Ramstad's bill, H.R. 1498, is focused on tempering the current built-in gains tax. While all these bills have merit, the broader the action, the better.

S corporations operate in every business sector of every state. Typically, they are family-owned and operated businesses or otherwise closely-held organizations that have been reliable engines of job growth and productivity for the domestic economy. The rules adopted in 1958 when S corporations were created, and as subsequently amended, are out of sync with modern economic realities. The S corporation reforms we propose would address the troubling gap between the antiquated laws established over forty years ago and the operating and capital needs of S corporations today. These reforms were developed after careful and thorough study. In short, these reforms would provide the boost, at a critical time, that thousands of small businesses in America need to continue the growth of American entrepreneurship and competitiveness, and they have the strong support of the United States Chamber of Commerce and other business organizations.

Chairman MCCRERY. Thank you, Mr. Alexander. Each of you should know that your prepared testimony that you submit will be in the record in their entirety. Now, Mr. Zarzar, if you would summarize yours in about 5 minutes, we would appreciate it.

STATEMENT OF ROBERT A. ZARZAR, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS; ACCOMPANIED BY LAURA M. MACDONOUGH, PAST CHAIR, S CORPORATION TAXATION TECHNICAL RESOURCE PANEL, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ZARZAR. Thank you, Mr. Chairman, Ranking Member. The AICPA appreciates this opportunity to present testimony on the importance of modernizing the laws that govern Subchapter S of the Internal Revenue Code. My name is Robert Zarzar and I am Chair of the Tax Executive Committee. Ms. Laura MacDonough, a past Chair of the AICPAs S Corporation Technical Resource Panel, is here with me.

The AICPAs members assist S corporations and their shareholders of all sizes and in all industries nationwide with choice of entity decisions; organizational, transactional and acquisitive structuring; operational and distribution planning; return preparation; and many other services required daily by S corporation clients.

It is from decades of close involvement with these small, mid-size and large clients that we have developed insight into a list of needs required to enable S corporations to do what they were intended to do all along: that is, provide a vehicle for small-scale entrepreneurs to grow and achieve success in their business endeavors.

Perhaps the greatest characteristics of S corporations have always been the one level of tax imposed, the familiar and time-tested corporate structure, and the ability to write off operational losses of a shareholder's tax return, primarily in the startup years.

Without digressing significantly from today's topic, we note that this Subcommittee's colleague, the Honorable Mr. Amo Houghton, has introduced legislation that would move entities toward Subchapter K and would do so with some very promising features, such as providing a means for all nonpublicly traded businesses to be taxed only at the end user level.

Now, because the emphasis of H.R. 22 is on the largely common law partnership and the untested and less structured LLC, the typical S corporation owner's zone of comfort has been stripped away, and the bill fails to entice small business entrepreneurs relatively happy with the structure of S corporation world. In the current climate, there exists a strong need to expand Subchapter S so that it will grow with the businesses created under its auspices.

Expanding this comfortable, and familiar, single-tax entity makes particular sense in light of the Administration's desire to see taxes imposed primarily on the end user.

In our written testimony, we have provided a more detailed list of recommendations with explanations as to why various changes are needed. Today I would like to highlight just a few of those items.

First in the category of reforms we might characterize as technical corrections, the new suggestion based on the recent Jobs and Growth Tax Relief and Reconciliation Act of 2003 (P.L. 108–27) is changed to the personal holding company and accumulated earnings taxes that reduced the tax rate to 15 percent. We believe that because the passive investment income provisions of section 1375 were intended to serve a similar function, the rate imposed on such earnings should likewise be reduced.

Second in that category, we believe that while significant progress has been made since 1996 in making ESBTs useable, Sections 304 and 305 of H.R. 1896 clarify two critical points and will significantly expand their use.

First, when an ESBT purchases S corporation stock by borrowing money, the trust should be able to deduct the related interest expense, as would any other type of taxpayer. There simply is no policy reason for this provision. Statutory authority for this deduction must be made clear. There is no apparent policy reason for its disallowance.

Second, routine powers of appointment contained in trusts that make an ESBT election run the serious risk of blowing an S corporation election simply because of the overly expansive definition of the potential current beneficiaries and the difficulty of modifying existing trust documents. If the powers are unexercised, they should be disregarded for this purpose, thus, allowing trust drafters and other users to get some sleep at night.

Next, we strongly recommend that the statute clarify that QSub elections were intended to be kept simple, without the needless trap for the unwary that the step transaction doctrine can present in unexpecting circumstances. Section 504 of H.R. 1896 takes care of this easy issue.

Other provisions of Congressman Shaw's excellent bill, such as Section 205 that encourages S corporations to make charitable contributions, H.R. 714 includes a similar provision, and Section 302 that can significantly increase the value of S corporation stock transferred as part of a divorce decree by allowing an ex-spouse to utilize otherwise unusable suspended losses. This provision would be even more family-friendly if it were even expanded to cover other Section 1041 spousal transfers, which don't happen to be incident to divorce.

Section 309 is important because it recognizes, by allowing an increase in basis to a shareholder/lender's S corporation indebtedness, that S corporations are frequently financed by shareholders who in turn borrowed the money from somewhere else, such as a related S corporation. Current law does not allow such a basis increase because the loan is not traced directly to the shareholder. Restructuring of such loans to pass muster under current law is the subject of substantial litigation and remains a major trap for the unwary. The AICPA strongly supports Section 309.

Finally, we understand that Mr. Shaw is considering the introduction of legislation that would remove one of the many entry barriers facing startup and growing S corporations and other small businesses; the current inability to elect to operate on a natural business year other than a calendar year. Such flexibility will provide young S corporations an additional tool to navigate its startup life cycle, and we strongly support enactment of that legislation.

Mr. Chairman, time today does not permit us to adequately praise the merits of the many provisions under consideration today. We sincerely thank you for your time. Ms. MacDonough and I would be happy to answer any questions you may have, and we would be happy to work with you and your staffs as you look to implement these important provisions. Thank you.

[The prepared statement of Mr. Zarzar follows:]

Statement of Robert A. Zarzar, Chair, Tax Executive Committee, American Institute of Certified Public Accountants

The American Institute of Certified Public Accountants (AICPA) appreciates the time and effort invested by the House Ways & Means Subcommittee on Select Revenue Measures to explore the need to modernize Subchapter S of the Internal Revenue Code. We strongly believe that such a need exists and offer below our thoughts and suggestions on H.R. 1896, The Subchapter S Modernization Act of 2003, which we generally support.

The Small Business Job Protection Act of 1996 and subsequent legislation has been very helpful in facilitating the use of S corporations. However, a number of additional reform measures are needed to: (1) clarify or correct existing legislation, or (2) recognize and remove the anti-competitive limitations on the growth of existing S corporations. Many of the needed changes have been addressed in the abovementioned bill, but some have not.

H.R. 1896, *The Subchapter S Modernization Act of 2003*

Sections 101 and 104: Members of family treated as 1 shareholder; Increase in number of eligible shareholders to 150. Both Sections 101 and 104 increase the number of permissible shareholders in an S corporation. Section 101 accomplishes this by providing that under certain circumstances, all members of a family are treated as a single shareholder. Section 104 simply increases the numeric limit.

We believe that an increase in the limit on the number of shareholders either numerically or through attribution to make Subchapter S more broadly available is generally a good policy. However, Section 101 is fairly complex and its benefits are narrower in scope relative to Section 104. It is not uncommon for a corporation to exceed the current limitation on the number of shareholders as a result of employee ownership; thus, while we are supportive of both provisions, we believe that Section 104 should be given precedence over Section 101. If an increase in the permissible number of shareholders to 150 does not meet the needs of those interested in the family shareholder provision, we suggest that the number be increased as appropriate, or in the alternative, that the limit on the number of eligible shareholders be removed entirely.

Sections 102, 201 and 202: Nonresident aliens allowed to be shareholders; Issuance of preferred stock permitted; Safe harbor expanded to include convertible debt. Each of these provisions is important because they would fundamentally change the way some S corporations raise funds to expand operations, hire employees, and expand research capacity for new product development. S corporations would find it easier to attract needed capital without complex structuring or loss of S status. To help achieve this goal, proposed Section 202(a) should be expanded to ensure that a loan from a venture capital firm or similar business can qualify for the straight debt safe harbor, even if such firm is primarily engaged in making equity investments.

Allowing nonresident aliens to be S corporation shareholders, or even holders of qualified preferred stock as defined in proposed Section 201(a), would eliminate a financing barrier that would have little cost to the government due to the extension of the partnership withholding rules, yet would help border state (and other) S corporations tremendously.

Sections 103, 401, 402 and 403: Expansion of bank S corporation eligible shareholders to include IRAs; Exclusion of investment securities income from passive income test for bank S corporations; Treatment of qualifying director shares; Recapture of bad debt reserves. The AICPA generally supports these provisions.

Sections 203 and 204: Repeal of excessive passive investment income as a termination event; Modifications to passive income rules. Termination of an S election simply because (1) the corporation has earnings and profits remaining from its history as a C corporation, regardless of whether the E&P was generated from passive income of the type prohibited by IRC section 1375, and (2) it earns too much passive income too often, does not further any rational policy goal. Consistent with the personal holding company (PHC) rules of section 541 of the Internal Revenue Code and following, the only penalty for generating the “wrong” kind of income should be an additional tax on the prohibited income, assuming a penalty must be imposed at all. Terminating the S election would be paramount to a double penalty that simply is not warranted. Repealing this terminating event will simplify the Code and S corporation record keeping.

Increasing to 60 percent of gross receipts the amount of passive investment income an S corporation may receive without being subject to the passive investment income tax further and appropriately conforms this tax to the PHC regime. Additionally, we support the removal of capital gains on the sale of stocks and securities from the category of passive investment income, which hasn't been a part of the PHC regime for about 40 years.

We also suggest that IRC section 1375(a) be changed to lower the tax rate on passive investment income to 15 percent, rather than tying it to the highest rate in IRC section 11(b). We believe this was an oversight in recently enacted Section 302(e) of the *Jobs and Growth Tax Relief and Reconciliation Act,*[1] where the rates for both the PHC and the accumulated earnings tax were similarly reduced.

Section 205: Adjustment to basis of S corporation stock for certain charitable contributions. We strongly support Section 205, which allows a stock basis increase for appreciated property contributed to a charity by an S corporation. Under current law, the Internal Revenue Service's position is that an S corporation shareholder must reduce his or her basis in the S corporation by the amount of any charitable contribution deduction flowing through from the S corporation to the shareholder. Thus, if an S corporation claims a fair market value deduction for a contribution of appreciated property, the S corporation shareholder must reduce his or her basis in the S corporation by such value. In the case of a partnership, the Internal Revenue Service has ruled that a partner's basis in his or her partnership interest should be reduced by his or her pro rata share of the partnership's basis in the property contributed. We believe that partnerships and S corporations should be treated similarly with respect to charitable contributions of property. Allowing a stock basis increase for appreciated property contributed to a charity by an S corporation would produce such a result and have the effect of preserving the intended benefit of a fair market value deduction for the contributed appreciated property, without recognition of the appreciation upon a subsequent sale of the stock. Section 205 would encourage charitable giving and remove a trap for unwary taxpayers who do not realize that gifting appreciated property through an S corporation effectively results in recognition of the gain inherent in the property when the stock of the S corporation is disposed of in a taxable transaction.

Section 301: Treatment of losses to shareholders. Subsection (a) provides that when an S corporation shareholder recognizes a loss upon the liquidation of the corporation, the portion of the loss that does not exceed the ordinary income basis of the shareholder's stock in the S corporation shall be treated as an ordinary loss. This provision appears to have the objective of allowing a shareholder to claim an ordinary loss upon liquidation of an S corporation to the extent that his or her basis in the S corporation is attributable to amounts reported as ordinary income as a result of the complete liquidation. This provision is certainly taxpayer favorable, because an ordinary loss can offset ordinary income, which is generally subject to tax at a significantly higher rate as compared to capital gain income, and is also not subject to the limitations on the use of capital losses. However, it is important to note that the provision may have the effect of overriding certain ordinary income provisions that were enacted to address concerns about receiving capital gains benefits for amounts previously claimed as ordinary deductions (e.g., depreciation recapture under IRC section 1245).

Subsection (b) clarifies that a shareholder's ability to deduct suspended passive activity losses in any given year is not dependent on the fact that an S corporation is generally not permitted to carry items forward or back. This provision should be enacted, as it will reduce litigation regarding the use of passive activity losses upon conversion to S status.[2]

Section 302: Transfer of suspended losses incident to divorce. IRC section 1366(d)(2) treats a shareholder's portion of S corporation suspended losses as incurred by the corporation with respect to that shareholder in the succeeding tax year. Under regulation section 1.1366–2(a)(5), the suspended losses are personal to a shareholder and cannot, in any manner, be transferred to another person. Thus, if a shareholder transfers 100 percent of his or her stock, his or her suspended losses are permanently disallowed. Accordingly, if, under IRC section 1041(a)(2), a shareholder transfers all of his or her stock in an S corporation to his or her former spouse as a result of divorce, any suspended losses or deductions with respect to such stock cannot be used by the spouse and, thus, disappear. This result is inequitable, unduly harsh, and needlessly complicates property settlement negotiations.

[1] P.L. 108–27.

[2] See *St. Charles Investment Co. v. Commissioner*, 23 F.3d 773 (10th Cir. 2000).

We support Section 302 because it allows for the transfer of a pro rata portion of the suspended losses when S corporation stock is transferred, in whole or in part, incident to divorce. We further support the expansion of Section 302 to cover all IRC section 1041 transfers to encourage legitimate tax-free transactions between spouses.

Section 303: Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries. IRC section 1361(c)(2) limits the types of trusts permitted to be S corporation shareholders. A qualified subchapter S trust (QSST) is one such permitted shareholder. For purposes of the IRC section 678(a) grantor trust rules, IRC section 1361(d)(1)(B) treats the QSSTs current income beneficiary as the owner of the portion of the trust consisting of S corporation stock. In effect, this causes the S corporation's items of income, loss, deduction and credit to flow directly to the income beneficiary.

When the QSST disposes of the S corporation stock, however, regulation section 1.1361–1(j)(8) treats the QSST, and not the income beneficiary, as the owner of the stock for purposes of determining and attributing the tax consequences of the disposition. This regulation is troublesome when the income beneficiary's flow-through losses are suspended under the IRC section 469 passive activity loss rules. Under IRC section 469(g), these suspended losses are freed up when a taxpayer's entire interest in a passive activity is transferred to an unrelated person in a fully taxable transaction. Because the income beneficiary is the taxpayer who is entitled to the suspended passive losses under the Code, but the trust is the taxpayer bearing the tax consequences of the gain on the stock sale under the regulations, current law is unclear about whether the QSST, the income beneficiary, or neither benefits from the suspended losses after the QSST disposes of the S stock. A similar problem arises where the losses are suspended under the IRC section 465 at-risk rules.

Section 303 treats the income beneficiary as the taxpayer that disposes of the stock and thus enables the beneficiary to utilize the suspended passive losses at least when the disposition of the S corporation stock represents a disposition of the beneficiary's entire passive activity. It also has the effect of increasing the income beneficiary's at-risk amount with respect to the S activity by the amount of gain recognized by the QSST on a disposition of S stock.

The AICPA supports this provision because the suspended losses would be freed up and utilized at the income beneficiary level and the QSST would have the proceeds of the sale to pay tax on the gain.

Sections 304, 305, 306 and 307: Deductibility of interest expense incurred by an ESBT to acquire S corporation stock; Disregard unexercised powers of appointment in determining potential current beneficiaries of ESBT; Clarification of ESBT distribution rules; Allowance of charitable contributions deduction for electing small business trusts. Under IRC section 641(c)(2)(C), the S portion of an ESBT's taxable income is computed taking into account only (1) items required to be taken into account under IRC section 1366; (2) gains or losses from the disposition of S corporation stock; and (3) to the extent provided in regulations, state and local income taxes or administrative expenses allocable to items (1) or (2).

Current regulations provide that interest expense incurred by an ESBT to acquire stock in an S corporation is allocable to the S portion of the trust, but is not deductible because it is not an administrative expense of the trust. While the position taken in the regulations may be technically supportable, tax policy cannot support this result. All other taxpayers are entitled to deduct interest incurred to acquire an interest in a passthrough entity and to disallow an ESBT a deduction for such interest is patently unfair. There is no indication that Congress intended to place ESBTs at a disadvantage relative to other taxpayers. Section 304 appropriately remedies this significant problem, greatly reducing the barriers to using these family trusts. We note, however, that a retroactive effective date should be applied to this provision to enable interest deductions on amended returns of taxpayers unaware of this trap at the time they structured purchases of such stock.

In addition, the current definition of "potential current beneficiary" is generally troublesome. In the context of powers of appointment, typical provisions in such trusts, such definition literally threatens the very use of ESBTs as S corporation shareholders. A typical example of the problem it creates follows:

> M creates a trust for the benefit of A. A also has a current power to appoint income or principal to anyone except A, A's creditors, A's estate, and A's estate's creditors. The potential current beneficiaries of the trust will be A and all other persons except for A's creditors, A's estate, and A's estate's creditors. This number will clearly exceed the numerical shareholder limit, whether it remains at 75 or increases to any finite number.

Section 305 removes the instability and trepidation of using ESBTs that contain powers of appointment to plan for the succession of family-owned S corporations. Nevertheless, we question whether there exists a need for eligibility restrictions on using ESBTs since the ESBT is taxed at the highest marginal rate, currently 35 percent, thus minimizing abuse to which they might otherwise be susceptible.

Section 306 conforms the ESBT distribution rules as they apply to the S and non-S portions of this unique trust to normal Subchapter J concepts regarding the treatment of separate shares.

It appears that Section 307 is intended to allow the S portion of an ESBT to claim a charitable contribution deduction for gifts of S corporation stock. It is unclear as to whether or not Section 307 accomplishes this and we believe that it may be necessary to modify the language to ensure the desired result and avoid unanticipated results. We would be happy to work with you in drafting appropriate revisions to this language.

Section 309: Back to back loans as indebtedness. The AICPA strongly supports Section 309. This provision removes a significant trap for the unwary, especially shareholders of small S corporations. IRC section 1366(d)(1) limits the amount of a shareholder's pro rata share of corporate losses that may be taken into account to the sum of (1) the basis in the stock, plus (2) the basis of any shareholder loans to the S corporation. The debt must run directly to the shareholder for the shareholder to receive basis for this purpose; the creditor may not be a person related to the shareholder. It is not uncommon for the shareholders of an S corporation to own related entities. Often times, loans are made among these related entities. Under current law, it is extremely difficult for the shareholders of an S corporation to restructure these loans in order to create basis in the S corporation against which losses of the S corporation may be claimed. The ability to create loan basis through the restructuring of related party loans has been the subject of substantial litigation and is an area of much uncertainty. Section 309 will protect these taxpayers from an unfair and unwarranted fate by providing that true indebtedness from an S corporation to a shareholder increases IRC section 1366(d) basis, irrespective of the original source of the funds to the corporation.

Section 501: Relief from inadvertently invalid qualified subchapter S subsidiary (QSub) elections and terminations. Under IRC section 1362(f), the IRS has authority to grant relief if a taxpayer inadvertently terminates its S corporation election or inadvertently makes an invalid S corporation election. The proposed QSub regulations would have allowed taxpayers to seek similar relief in the case of inadvertent terminations of QSub status. However, the final QSub regulations eliminated this relief because of IRS concerns about the scope of its statutory authority. It is virtually certain that taxpayers will inadvertently make invalid QSub elections or terminate QSub status. Section 501 will be very helpful because it permits the Service appropriate discretion to grant relief in such cases, applying standards similar to those currently used in the case of inadvertently invalid S corporation elections and terminations.

Section 503: Treatment of the sale of interest in a qualified subchapter S subsidiary. Under current law, an S corporation may be required to recognize 100 percent of the gain inherent in a QSub's assets if it sells anywhere between 21 and 100 percent of the QSub stock. Many taxpayers that sell less than 100 percent will be unpleasantly surprised by this trap for the unwary. This result is counter to sound tax policy because the S corporation, in effect, is required to recognize gain on assets without making any disposition of those assets. The QSub regulations include an example suggesting that this result can be avoided by merging the QSub into a single member LLC prior to the sale, then selling an interest in the LLC (as opposed to stock of the QSub). The law should be simplified to remove this trap and to eliminate needless restructuring to avoid an inappropriate tax result. Section 503 causes an appropriate percentage of gain to be recognized while removing the complicated and needless restructuring requirement.

Section 504: Exception to application of the step transaction doctrine for restructuring in connection with making qualified subchapter S subsidiary elections. The intent of Congress seemed clear in 1996 when it explained "[U]nder the provision, if an election is made to treat an existing corporation . . . as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under IRC sections 332 and 337 immediately before the election is effective." [3] This "guarantee" of tax-free QSub elections is expected by S corporation taxpayers who are not accustomed to the complex judicial doctrines of Subchapter C and, if respected, would eliminate a trap created from the Service's interpretation of the statute. We note that while there may be technical justification for application of the step transaction doctrine,

[3] See H.R. Rep. No. 104–586 at 89 (1996)

congressional intent, simplicity concerns inherent in S corporations, and the fact that most S corporation taxpayers would unintentionally subject their transactions to significant and avoidable taxation, warrants the statutory clarification proposed in Section 504.

Section 601: Elimination of all earnings and profits attributable to pre-1983 years. Section 1311 of the Small Business Job Protection Act of 1996 eliminated certain pre-1983 earnings and profits of S corporations that had S corporation status for their first tax year beginning after December 31, 1996. This provision should apply to *all* corporations (C and S) with pre-1983 S earnings and profits without regard to when they elect S status. There seems to be no policy reason why the elimination was restricted to corporations with an S election in effect for their first taxable year beginning after December 31, 1996.

Section 602: No gain or loss on deferred intercompany transactions because of conversion to S corporation or qualified subchapter S subsidiary. We support this provision because it is consistent with the policy behind the consolidated return provisions relating to intercompany transactions, which is that the gain should be deferred until property leaves the economic unit consisting of the consolidated group. Simply electing S corporation or QSub status should not cause a triggering of these gains. We note, however, that a modification to IRC section 1374, relating to the built-in gain tax, may be warranted to ensure that such gains do not inappropriately escape corporate level taxation.

Other Legislative Recommendations

H.R. 1896, if enacted, would address many of the issues currently faced by S corporations and corporations desiring to elect S corporation status. However, there are other concerns that are not addressed by the legislation. Two of these concerns are discussed below.

Elimination of LIFO Recapture Tax. Often times the most significant hurdle faced by a corporation desiring to elect S corporation status is the LIFO recapture tax under IRC section 1363(d). In many cases, this tax makes it cost-prohibitive for a corporation to elect S status. The LIFO recapture tax was enacted in 1987 in response to concerns that a taxpayer using the LIFO method of accounting, upon conversion to S corporation status, would avoid corporate level tax on LIFO layers established while the corporation was a C corporation. While this may be a legitimate policy concern, to require the inclusion of the LIFO reserve into income upon conversion to S status to address this concern appears unwarranted. We recommend that IRC section 1363(d) be repealed and that IRC section 1374 be amended to provide that the ten year recognition period not apply with respect to any LIFO inventory held by a corporation on its date of conversion to S status.

Expansion of post-termination transition period to include filing of amended return. We also suggest that the post-termination transition period of IRC section 1377(b)(1) be expanded to include the filing of an amended return for an S year. We recognize that there is no statutory provision permitting the filing of an amended return; such a return is a "creature of administrative origin and grace." If it is not possible to codify the above recommendation, the bill should require the Secretary of the Treasury to prescribe this result by regulation. To prevent abuses, it may be advisable to limit the amount of losses that may be taken into account under IRC section 1366(d)(3) and the amount of distributions that may be taken into account under IRC section 1371(e) to the net increase in a shareholder's basis resulting from the adjustments made on the amended return giving rise to the post-termination transition period.

Ability to elect fiscal years. We recognize the difficulties—particularly in today's economic environment—for start-up businesses to make it through the first several years of their existence. A very substantial percentage of those new businesses are S corporations. One of the barriers to efficient operation of these start-ups is the artificial requirement that, generally, all such new S corporations (and partnerships) must use a calendar year as their tax year, regardless of what their "natural" business year would be.

Therefore, we would like to call your attention to, and express our appreciation for, the efforts of Congressman Shaw, to promote legislation that proposes to give most small business start-ups an additional tool to successfully navigate its start-up life cycle by providing the flexibility to adopt any fiscal year-end from April through December. Such flexibility would (1) allow start-ups to spread their workloads and ease recordkeeping burdens; (2) maximize their access to professional advisors; and (3) provide them with additional operating resources. With the continued interest that small businesses have in electing S corporation status and with the important progress S corporations will achieve with the enactment of the H.R. 1896 provisions, allowing S corporations fiscal year flexibility will likewise enhance small business survival.

* * * * *

Thank you for taking the time to request and consider our input as a part of today's hearing on S Corporation Modernization. The AICPA would be happy to work with this Subcommittee and its staff as it explores the possibility of moving these important changes forward. You may contact Robert Zarzar, Chair of the Tax Executive Committee at (202) 414–1705 or Robert.zarzar@us.pwc.com; Kenneth N. Orbach, Chair of the S Corporation Taxation Technical Resource Panel at (561) 297–2779 or orbach@fau.edu; or Marc A. Hyman, AICPA Technical Manager at (202) 434–9231 or mhyman@aicpa.org.

Chairman MCCRERY. Thank you, Mr. Zarzar. I am told that Ms. MacDonough is not going to testify, that being from Ernst & Young, she is just here to keep an eye on Pricewaterhouse.

[Laughter.]

Mr. ZARZAR. Well said, but she will provide some technical support to some questions you may have. Thank you.

Chairman MCCRERY. Yes, sir. Mr. Cloutier?

STATEMENT OF C.R. "RUSTY" CLOUTIER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MIDSOUTH BANK, LAFAYETTE, LOUISIANA, ON BEHALF OF AND CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. CLOUTIER. Mr. Chairman, Ranking Member, Ms. Tubbs Jones, and Members of the Subcommittee, my name is Rusty Cloutier. I am Chairman of the ICBA and President of MidSouth Bank, a $400 million community bank located in Lafayette, Louisiana. I am pleased to appear today on behalf of the ICBA to share with you our views to reform and simplify Subchapter S corporation rules.

For generations, independent banking institutions have played a special role in American communities and in thousands of neighborhoods. The bulk of our Nation's commercial banks are community banks. Community-based banks remain the underpinning of millions of consumers' family-owned business, local merchants, manufacturers, and family farms which depend on the availability of local bank lending for their credit needs.

Importantly, community banks serve as a key source of credit and other financial services to small business, the most prolific job creation sector of our economy. Allowing community banks to operate more efficiently as Subchapter S enables them to improve their viability and helps prevent the punitive of double taxation of income, a goal of a sound tax and economic policy.

The recent tax relief bill passed by Congress and signed into law by President Bush made great strides in reducing punitive double taxation of corporation income by reducing the tax on dividends.

As our Nation continues to debate tax policy options to foster economic growth, enhance savings, and job opportunities, the ICBA believes reforming the onerous Subchapter S rules will be greatly beneficial.

The ICBA has researched and has recommended several S corporation simplification measures for consideration that we believe will improve the viability of more small businesses and community-based banks. We are delighted that many of these simplification measures have been introduced in the 108th Congress. The ICBA supports the important Subchapter S reform bills being examined here today, especially H.R. 714, the Small Business and Financial Institution Tax Relief Act, introduced by Representative Scott McInnis. The ICBA urges the Committee on Ways and Means Members to support this much-needed reform legislation to help ensure its enactment in the current Congress.

Community banks only recently were able to avoid punitive double taxation by electing Subchapter S. In 1996, Congress passed the Small Business Job Protection Act (P.L. 104–188) that allowed small banks to be eligible to elect Subchapter S corporations status for the first time.

For example, since 1997, 23 of the 147 commercial banks in my State of Louisiana had elected the benefits of Subchapter S tax structure. Unfortunately, Mr. Chairman, many small community banks have been obstructed from converting to S corporation status and benefited from Congress's intended relief because of the complex rules that we would like to have addressed with tax simplification.

This conclusion was further supported by a comprehensive U.S. General Accounting Office study in June 2000. Notably, an additional 16 percent of all small community banks surveyed indicated that they are interested in making the declaration of Subchapter S election, pending resolution of the various Subchapter S glitches that prohibit this tax status.

Currently, before making the S corporation election, many community banks must first overcome some difficult obstacles not faced by other corporate tax structures such as limited liability partnerships (LLPs) or LLCs.

The obstacles most often outlined by community bankers include the existing limitations on the types of shareholders, existing limitations on the number of shareholders, limitations on options for raising capital, specifically the inability to issue preferred stock, and uncertainty regarding the passive income tax investment rules and the uncertainty regarding the treatment of director's shares.

The ICBA strongly supports H.R. 714 and other excellent Subchapter S reform bills now pending in Congress because they would help reduce many of the ambiguities and obstacles in the current law. Passing H.R. 714 would enhance the ability of community banks to be able to utilize Subchapter S status as intended by Congress.

The ICBA's top S corporation reform recommendations to this Committee include allowing IRA shareholders to be eligible as Subchapter S corporation shareholders. Many community banks have been caught in the unintended trap of having the law passed in 1996 when they had existing IRA shareholders. We would recommend that the shares people owned before 1997 be allowed.

The ICBA recommends allowing community bank S corporations to issue certain preferred stock. We also recommend reforming the treatment of bank director shares, and we recommend increasing the number of Subchapter S corporation shareholders to 150 and counting family members as one shareholder.

In conclusion, the Tax Code simplification in the S corporation area would go a long way in allowing community-based banks to convert to an S corporation status, as Congress intended.

We enthusiastically support the bipartisan Subchapter S reform bills H.R. 714, H.R. 1896, and H.R. 1498. Each of these bills would help community banks better utilize Subchapter S status and improve their ability to provide the needed capital and credit in their communities.

Mr. Chairman, ICBA looks forward to working with you on this legislation and are happy to answer any questions today. Thank you.

[The prepared statement of Mr. Cloutier follows:]

Statement of C.R. "Rusty" Cloutier, President and Chief Executive Officer, MidSouth Bank, Lafayette, Louisiana, on behalf of and Chairman, Independent Community Bankers of America

Mr. Chairman, Ranking Member McNutly, and members of the Committee, my name is Rusty Cloutier. I am Chairman of the Independent Community Bankers of America ("ICBA")[1] and President of MidSouth National Bank, a $400 million community bank located in Lafayette, Louisiana. I am pleased to appear today on behalf of the Independent Community Bankers of America to share with you our views on ways to reform and simplify subchapter S corporation rules. Allowing small businesses to operate as Subchapter S entities helps prevent the punitive double taxation of income, a key goal of sound tax policy.

The Independent Community Bankers of America greatly appreciates the opportunity to contribute several Code simplification suggestions for consideration that we believe will improve the viability of more small businesses and community-based banks. These simplifications measures have been adopted from a comprehensive ICBA/Grant Thornton LLP tax study and focus on simplification of restrictive S corporations rules.[2] We are delighted that many of these simplification measures have been drafted into legislation pending in the 108th Congress. ICBA supports these important subchapter S reform bills, which include:

- The *"Small Business and Financial Institutions Tax Relief Act of 2003,"* H.R. 714, introduced by Rep. Scott McInnis (R–CO) of the House Ways and Means Committee.
- The *"Subchapter S Modernization Act of 2003,"* H.R. 1896, introduced by Rep. Claw Shaw (R–FL) and Rep. Bob Matsui (D–CA) of the Ways and Means Committee.
- The *"Small Business Opportunity and Growth Act of 2003,"* H.R. 1498, introduced by Rep. Jim Ramstad (R–MN).

We applaud these excellent legislative efforts to simplify the current onerous and restrictive subchapter S corporation rules so that small businesses can benefit from a more user-friendly tax code. The ICBA urges the Ways and Means Committee members to support these much-needed reform measures and to help ensure they are enacted in the current Congress.

Background

In 1996, Congress passed the Small Business Job Protection Act of 1996 that allowed small banks to be eligible to elect S Corporation status for the first time starting in tax year 1997.[3]

Unfortunately, many community banks have been obstructed from converting to S corporations and benefiting from Congress's intended relief because of technical rules and community-bank specific regulations that could be addressed with tax

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[1] ICBA is the primary voice for the nation's community banks, representing some 4,600 institutions with 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $526 billion in insured deposits, $643 billion in assets and more than $402 billion in loans for consumers, small businesses and farms. For more information visit www.icba.org.

[2] "Community Bank Tax Relief and Simplification Options," a study prepared for the Independent Community Bankers of America by Grant Thornton LLP, 2003.

[3] Public Law 104–188.

simplification measures. This conclusion was further supported by a comprehensive General Accounting Office study in June, 2000.[4]

Notably, an additional 16 percent of all the small banks recently surveyed indicated that they were interested in making the S Corporation election pending resolutions of the various subchapters S glitches that prohibit using this tax status.[5]

Currently, before making the S Corporation election community banks must first overcome some difficult obstacles not faced by other corporate tax structures such as Limited Liability Partnerships (LLPs) or Limited Liability Corporations (LLCs) while attempting to avoid disrupting their operations or disenfranchising many of their existing shareholders.[6] The obstacles most often outlined by community bankers include:

- Existing limitations on the types of shareholders,
- Existing limitations on the number of shareholders,
- Limitations on the options for raising capital (e.g., inability to issue preferred stock),
- Uncertainty regarding the possible application of the passive investment income tax, and
- Uncertainty regarding the treatment of director's shares.

The excellent subchapter S reform bills now pending in Congress would help reduce many of these ambiguities and obstacles in the current law and would enhance the ability of community banks to be able to utilize S Corporation status as intended by Congress.

ICBA Recommended Subchapter S Reforms

Allow IRAs as Eligible S Corporation Shareholders

Current law severely restricts the types of individuals or entities that may own S Corporation stock.[7] For tax years beginning after December 31, 1997, acceptable S Corporation shareholders generally include:

- Any individual, except for a nonresident alien;
- Estates;
- Certain trusts;
- Certain tax-exempt organizations; and
- Employee stock ownership plans (ESOPs).

Individual Retirement Accounts (IRAs) are not eligible S Corporation shareholders. Many community banks have been caught in an unintended trap because they had IRA shareholders prior to the 1996 law change that allowed banks to choose subchapter S status the first time in tax year 1997. Eliminating ineligible classes of stock and ineligible shareholders prior to the beginning of the first S Corporation tax year has been a significant barrier to community banks otherwise interested in making the S election. IRAs often hold significant portions of bank stock, thereby limiting banks' ability to elect S Corporation status. In many cases, banks find it virtually impossible to eliminate the significant amount of stock owned by IRAs due to capital constraints.

To address this community bank IRA shareholder glitch that prevents the viable use of subchapter S, ICBA recommends allowing IRAs to hold S Corporation stock. Specifically, ICBA recommends grandfathering existing community bank IRA shareholders in place as of 1997 and not taxing IRA shareholders on the S Corporation earnings allocated to the IRA shareholders in a manner consistent with the treatment of S Corporation earnings allocated to ESOPs.

ICBA believes this reform will grant more community banks, now obstructed from making the S Corporation election, the added flexibility they need to have in dealing with IRA shareholders. Community banks interested in making the S Corporation election would no longer need to compel IRA shareholders to either sell their shares to the community bank or to third parties who are eligible S Corporation shareholders. In many cases, eliminating IRA shareholders proves an impossible task or in some cases, buyout costs puts a severe strain on community bank capital.

ICBA believes including IRA shareholders as eligible S Corporation shareholders by grandfathering existing bank IRA shares would provide significant relief to community banks and eliminate the high cost of eliminating bank stock held in IRAs

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[4] U.S. General Accounting Office, "Banking Taxation, Implications of Proposed Revisions Governing S-Corporations on Community Banks," June 2000. (GAO/GGD–00–159).
[5] Grant Thornton LLP, Ninth Annual Survey of Community Bank Executives.
[6] Ibid.
[7] Internal Revenue Code § 1361(b)(1).

Exempt Sale of Community Bank Stock by IRA to IRA Owner from Prohibited Transaction Treatment

Another alternative recommended reform to address the IRA shareholder problem that often prevents converting to subchapter S is to exempt the sale of community bank IRA-held stock from prohibitive transaction tax treatment. Under current law, the sale of IRA assets to a "disqualified party" is a prohibited transaction.[8] Prohibited transactions are defined in Internal Revenue Code § 4975.[9]

However, the owner of the IRA is a disqualified party and is prohibited from purchasing the community bank's stock from the IRA. The sale of plan assets to a disqualified party is prohibited no matter what price the owner is willing to pay the IRA for the stock. The penalty to an IRA for entering into a prohibited transaction is harsher than that applied to a prohibited transaction by a qualified plan. IRAs that participate in prohibited transactions taint the entire fund and the tax exemption is lost. The account ceases to be an IRA on the first day of the taxable year in which the prohibited transaction occurs.[10]

IRAs frequently hold community bank stock, resulting in a significant obstacle to banks that desire to make the S Corporation election. Only "qualified" plans, not IRAs, can be shareholders in an S Corporation. Accordingly, if a community bank decides to convert to S Corporation status, it must re-purchase the stock from the IRA. Often, the owner of the IRA does not want to give up the future benefit of stock ownership, and would like to purchase the stock from the IRA rather than having the community bank redeem the stock. The Department of Labor has granted exemptions, on a case-by-case basis, from the prohibited transaction rules when the IRA wanted to sell stock to a disqualified party.[11] However, applications must be submitted for each individual case and are time consuming and expensive.

ICBA recommends allowing owners of IRAs holding the stock of a community bank making the S Corporation election to purchase the subject securities from the IRAs. This can be accomplished by amending IRC § 4975 or IRC § 408 to alleviate the penalty associated with an IRA selling one of its assets to its owner.

This reform would make it easier for community banks interested in making the S Corporation election to eliminate ineligible IRA shareholders. Community banks will not have to drain valuable resources to buy back stock held in IRAs. Therefore, more community banks will be able to make the S Corporation election and improve their competitive position by avoiding the double taxation of income that applies to C Corporation banks.

Allow Community Bank S Corporations to Issue Certain Preferred Stock

Current law only allows S Corporations to have one class of stock outstanding.[12] C Corporations that want to make the S Corporation election must eliminate any second class of stock prior to the effective date of the S Corporation election. Issuing a second stock class by the S Corporation terminates its S Corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so that they can protect their status as an independent community bank and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S Corporation banks are not allowed to issue preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S Corporation purposes. This would help more community banks become eligible to make the S Corporation election as well as help those that currently have preferred stock outstanding would choose S Corporation status. Allowing bank S Corporations to issue preferred stock would allow them to reduce the burden of double taxation and, at the same time, fund future growth.

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[8] Internal Revenue Code § 4975(c)(1)(A).
[9] Internal Revenue Code § 408(e)(2)(A).
[10] Internal Revenue Code § 408(e)(2).
[11] (PTE 98–59) 63 FR 69326, 12/16/98 (25 BPR 2673, 11/16/98).
[12] Internal Revenue Code § 1361(b)(1)(D).

Reform the Treatment of Director Qualifying Stock for Purposes of the S Corporation and QSSS Elections

Because an S Corporation may have only one class of stock outstanding,[13] in most cases, the S Corporation election is terminated if the bank issues a second class of stock. A director of a national bank is generally required to own stock in the bank to assure that the individual has a sufficient financial interest in the bank to be vigilant in protecting the bank's interests.[14] A number of states have similar requirements for state chartered banks. In some cases, the state may require bank directors to hold bank subsidiary stock.

In some cases, stock issued by community banks or their holding companies to bank directors may not convey all of the economic interests conveyed to other shareholders. This type of director qualifying stock is issued solely to comply with the federal or state regulatory requirements. However, in this situation, the IRS may still determine that director qualifying stock is a second class of stock due to economic restrictions. Such an action by the IRS makes the bank ineligible to make the S Corporation election. Current rules are ambiguous as to whether director-qualifying stock, subject to substantial economic restrictions, held at the bank subsidiary level prevents the parent from making the Qualified Subchapter S Subsidiary (QSSS) election.[15] Consequently, many banks with restricted director's stock have undoubtedly been weary of making the S Corporation election given the uncertainty surrounding the treatment of director qualifying stock. A number of banks are waiting for definitive IRS guidance on this issue. The results of a Grant Thornton's survey of community bank executives indicated that the uncertainty of the treatment of director qualifying stock is a significant obstacle for over 6 percent of the banks that are considering making the S Corporation election.[16]

ICBA recommends not treating director-qualifying stock, subject to substantial economic restrictions, when issued by bank S Corporations or by bank subsidiaries of an S Corporation bank holding company, as stock for S Corporation purposes. Additionally we recommend excluding bank director shares required by bank regulations from inclusion in the number of shareholders subject to the limitation under subchapter S rules. ICBA believes more banks will be able to make the S Corporation election when the uncertainty surrounding the treatment of director qualifying stock is eliminated.

Increase Maximum Number of S Corporation Shareholders to 150 and Count Family Members as One Shareholder

When the S Corporation rules were first enacted, the maximum number of shareholders was 10.[17] Throughout the period 1976–1982 Congress made a series of legislative changes to increase the number to 35. The Small Business Job Protection Act increased the maximum number of eligible S Corporation shareholders from 35 to 75 for tax years beginning after December 31, 1996.[18]

In many cases community banks have made a decision to assure that their institutions are widely owned, often by members of the communities they serve. The provision of the S Corporation rules limiting the number of shareholders to no more than 75 often forces community banks that wish to become an S corporation to disenfranchise shareholders, severely limit ownership and its ability to raise capital in the future. Additionally, other corporate structures such as a LLP or LLC do not have any limitation on the number of shareholders.

Unfortunately, community banks with more than 75 shareholders that decide that making the S Corporation election is beneficial must somehow force out some of their shareholders—even when they would prefer to be more broadly held. Efforts

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[13] Internal Revenue Code § 1361(b)(1)(D).

[14] 12 U.S.C. section 72.

[15] The Small Business Job Protection Act added IRC § 1361(b)(3) that allows an S corporation to own a qualified subchapter S subsidiary (QSSS). A subsidiary qualifies as a QSSS if:

- the subsidiary would be eligible to elect subchapter S status if its stock were owned directly by the shareholders of its S corporation parent;
- the S corporation parent owns 100 percent of the subsidiary's stock; and
- the parent elects to treat the subsidiary as a QSSS.

If the QSSS election is made, the subsidiary is not treated as a separate taxable entity, and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

[16] "Community Banks: A Competitive Force," Sixth Annual Survey of Community Bank Executives, Grant Thornton LLP.

[17] See former Internal Revenue Code § 1371(a)(1), as in effect for taxable years starting before January 1, 1977.

[18] Internal Revenue Code § 136(b)(1)(A).

to force shareholders out through a reverse stock split or through the formation of a new holding company is generally a very thorny and expensive alternative.

ICBA recommends increasing the maximum number of allowable S Corporation shareholders to 150 and counting family members that are not more than three generations removed from a common ancestor as one shareholder for purposes of the shareholder limitation. ICBA believes that increasing the number of allowable shareholders will allow more community banks to make the S Corporation election and, at the same time, continue to be widely owned by members of their communities.

Exclude Bank Income from Passive Investment Income Tax

S Corporations with accumulated C Corporation earnings and profits are subject to a 35 percent tax on "passive investment income" exceeding 25 percent of gross receipts for any year.[19] Additionally, a company's S Corporation status is terminated if the 25 percent limit is exceeded for three consecutive years.[20] Passive investment income generally includes:

- Royalties
- Rents
- Dividends
- Interest
- Annuities, and
- Gains on sales of stock and securities.[21]

Passive investment income does not include gross receipts directly derived from the active and regular conduct of a lending or finance business.[22] Gross receipts directly derived in the ordinary course of a trade or business of lending or financing include gains (as well as interest income) from loans originated in a lending business. Interest earned from the investment of idle funds in short-term securities, however, does not constitute gross receipts directly derived in the ordinary course of business.[23] IRS Notice 97–5 generally provides that gross receipts directly derived in the ordinary course of a banking business are not passive investment income for purposes of the passive investment income tax. Income from the following assets are considered part of the active and regular conduct of a banking business:

- Loan, participations, or REMIC regular interests;[24]
- Equity investments needed to conduct business (FHLB stock etc.);[25]
- Assets pledged to a 3rd party to secure deposits or business;[26] and
- Investment assets needed for liquidity or loan demand.[27]

As a result, income and gain from these assets will not be considered subject to the passive investment income limitation applicable to S Corporations.

Treasury and the IRS believe that the special provisions of the Internal Revenue Code that apply to banks should apply only to the specific state-law entity that qualifies as a bank under IRC § 581. They believe that the special bank treatment of items should not apply to nonbanks, even if the nonbank is affiliated with a bank and the parent makes the Qualified Subchapter S Subsidiary (QSSS) election with respect to all of its subsidiaries.[28]

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[19] Internal Revenue Code § 1375(a).
[20] Internal Revenue Code § 1362(d)(3)(A).
[21] Internal Revenue Code § 1362(d)(3)(C)(i).
[22] Internal Revenue Code § 1362(d)(3)(C)(iii).
[23] Treas. Reg. § 1.1362–2(c)(5)(iii)(B)(2).
[24] All loans and REMIC regular interests owned, or considered to be owned, by the bank regardless of whether the loan originated in the bank's business. For these purposes, securities described in section 165(g)(2)(C) are not considered loans.
[25] Assets required to be held to conduct a banking business (such as Federal Reserve Bank, Federal Home Loan Bank, or Federal Agricultural Mortgage Bank stock or participation certificates issued by a Federal Intermediate Credit Bank which represent nonvoting stock in the bank).
[26] Assets pledged to a third party to secure deposits or business for the bank (such as assets pledged to qualify as a depository for federal taxes or state funds).
[27] Investment assets (other than assets specified in the preceding paragraphs) that are held by the bank to satisfy reasonable liquidity needs (including funds needed to meet anticipated loan demands).
[28] The Small Business Job Protection Act added IRC § 1361(b)(3) permitting an S Corporation to own a qualified subchapter S Subsidiary (QSSS). A subsidiary qualifies as a QSSS if (1) the subsidiary would be eligible to elect subchapter S status if its stock were owned directly by the shareholders of its S Corporation parent; (2) the S Corporation parent owns 100 percent of the subsidiary's stock; and (3) the parent elects to treat the subsidiary as a QSSS. If the QSSS election is made, the subsidiary is not treated as a separate corporation for tax purposes, and all

The amount of investment assets needed for liquidity or loan demand can be very subjective, with most banks not wanting to gamble that an IRS agent may disagree with their estimates. Banks find this uncertainty regarding the possible application of the passive investment income tax (and possible S Corporation termination) to be problematic and many have delayed or discarded their decision to make the S Corporation election.

ICBA recommends excluding bank income from the passive investment income tax imposed by IRC § 1375, effective for tax years beginning after December 31, 1996. Bank income would be defined as all income from any corporate entities that qualify as a bank under IRC § 581 and from any 100 percent owned subsidiaries of a bank.

ICBA believes that reforming the onerous passive income rules will eliminate the uncertainty of the unintended application of the passive investment income tax (and possible S Corporation termination). Banks no longer will have the potentially significant and uncertain treatment of passive investment income hanging over their decision-making process. By treating all bank income as earned from the active and regular conduct of a banking business, banks will no longer face the conundrum of evaluating investment decisions based on tax considerations rather than on more important safety and economic soundness issues.

Conclusion

Tax code simplification in the S corporation area would go a long way in allowing community-based banks to convert to S corporation status as Congress intended in 1996. Many community banks and small businesses find that current technical barriers to making the conversion from a C Corporation to an S Corporation are too great to overcome. Current restrictions and complicated rules for S Corporation status make the conversion from C Corporation status unattainable for many community banks, thwarting Congress's intended relief from punitive double taxation. ICBA believes reforming and simplifying onerous subchapter S corporation rules will create a tax code that is small-business friendly and improve community banks' ability to meet the lending needs in their local communities

Restrictions on S Corporation stock ownership and the shareholder limit are, in general, some of the most difficult hurdles for community banks to overcome. These S corporation restrictions do not apply to other corporate forms of business. The limit on the number of S Corporation shareholders continues to pose a significant barrier to many community banks. Often, community bank ownership has passed from generation to generation, expanding with each generation. It does not take many generations of family growth for community banks to exceed the S Corporation stockholder limit.

The ICBA recommends several subchapter S Corporation rule changes that would greatly simplify the ability for community banks to elect Subchapter S status as Congress intended. These include, grandfathering bank IRA shareholders as eligible S corporation shareholders, allowing community bank S corporations to issue preferred stock, reforming onerous director's share rules, increasing the allowable number of S Corporation shareholders to 150, treating family members as one shareholder, and reforming the application of passive income rules.

The ICBA is delighted to see the Ways and Means Committee examining the reform options presented in the solid subchapter S reform bills now pending in the 108th Congress. We enthusiastically support the bipartisan subchapter S reform bills: H.R. 714, H.R. 1896, and H.R. 1498. Each of these bill would help community banks better utilize subchapter S tax status and improve their ability to provide needed capital and credit in their local communities.

Thank you Mr. Chairman for the opportunity to appear before you today. ICBA looks forward to working with you and the committee to ensure the enactment of beneficial S corporation reforms.

Chairman MCCRERY. Thank you, Mr. Cloutier. Mr. True?

the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S Corporation.

STATEMENT OF DAVE TRUE, OWNER, TRUE RANCHES, CASPER, WYOMING, ON BEHALF OF THE NATIONAL CATTLEMEN'S BEEF ASSOCIATION

Mr. TRUE. Thank you very much, Mr. Chairman and Ranking Member of this Subcommittee, for the opportunity to be here with you today.

My name is Dave True and I, with my family, own True Ranches, a calf and cattle-feeding operation in the Eastern third of Wyoming. In addition to this cattle operation, our family is actively involved in a few other businesses. We are engaged in the energy industry, through the operations of exploration and production of oil and gas, drilling rigs, trucking services, pipelines, oil field supply, and marketing services.

Additionally, our family owns a community bank with $300 million in footing. So, the proposed Subchapter S modifications affecting banking, especially the qualified director's shares provision, are of interest to us also.

I am here today representing the NCBA and our nearly 250,000 members and affiliate members nationwide. The NCBA follows a very simple and straightforward mission of working to increase profit opportunities for cattle and beef producers by enhancing the business climate and building consumer demand.

Obviously, Subchapter S laws materially affect the cattle industry business climate. Despite the fact that many of the fundamental aspects of raising cattle are the same as they were 100 years ago. The modern climate for conducting today's beef operations means that business structure and operation principles are often just as important as the selection of the herd sire.

The NCBA believes that there are a number of actions this body can take that will help to create an environment that allows producers to establish a business model that will work today and on into the future. Providing a wider range of workable and flexible options for producers in their business structure may be one of the most critical components in building successful operations.

One such option would be to allow S corporations to change to a noncorporate form of business without incurring the tax costs typically imposed on a corporate liquidation.

One of the most important decisions for a founder of a business is the choice of entity. In today's business climate, the ability to adapt to changes in economic conditions is also becoming critical. For the family business, the choice is inseparable from the owner's preference as to how he wants to deal with other family co-owners.

For all of these reasons, choice of entity is therefore potentially one of the most important aspects of business planning. Until the rise of the LLC in the mid 1990s, the S corporation remained, for all practical purposes, the sole means for these producers to obtain the benefit of limited liability without the complex corporate laws.

Although the first LLC statute was passed in Wyoming in 1977, the Federal income tax characterization of the entity was uncertain. Following the IRS issuance of Revenue Ruling 88–76, which made clear that limited liability is not, per se, a barrier to partnership tax status, interest in LLCs increased substantially.

Unfortunately, the sea change in choice of entity laws has provided little value to owners of S corporations because of the tax on a conversion to a noncorporate form of business. Partnerships and entities taxed as partnerships have been able to take advantage of the latest developments in this area of law, generally, without adverse tax effects, while S corporations are hobbled with corporate formalities.

Lessening these formalities is extremely important, and consequently we are very supportive of the legislation that is in front of this Subcommittee today. An S corporation and its shareholders could benefit from a window in time within which to convert to an LLC, but without incurring the tax costs of liquidation.

In summary, the S corporation election itself and improvements over the years have been giant strides in removing tax consideration in choice of entity. In addition to ongoing improvements to Subchapter S laws, the next step in the process is allowing these S corporations that can be more efficiently functioning as an LLC the one-time opportunity to make the conversion without tax cost being the controlling factor.

Until these conversions can be accomplished, the task of reducing the role of taxes in choosing a business form or in adapting to changing economic conditions will remain unfinished.

Mr. Chairman, on behalf of NCBA and myself, I am very grateful for the opportunity to be here in front of you today. Thank you.

[The prepared statement of Mr. True follows:]

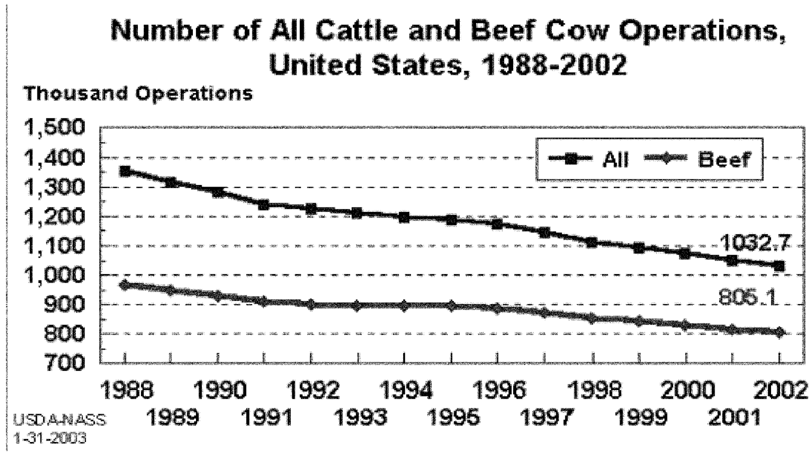
Statement of Dave True, Owner, True Ranches, Casper, Wyoming, on behalf of the National Cattlemen's Beef Association

Thank you, Mr. Chairman, and members of the Subcommittee for this opportunity to testify today. My name is Dave True and I, along with my family, own True Ranches, a cow/calf and cattle feeding operation in the eastern third of Wyoming, headquartered in Casper. I am here today representing the National Cattlemen's Beef Association (NCBA) and our nearly 250,000 members and affiliate members nationwide. NCBA follows a very simple and straight forward mission of "Working to increase profit opportunities for cattle and beef producers by enhancing the business climate and building consumer demand." Our testimony today will focus on several concerns we see in the future and some solutions that we have identified to address concerns of the past—all focused on creating a business climate that allows producers to be more profitable.

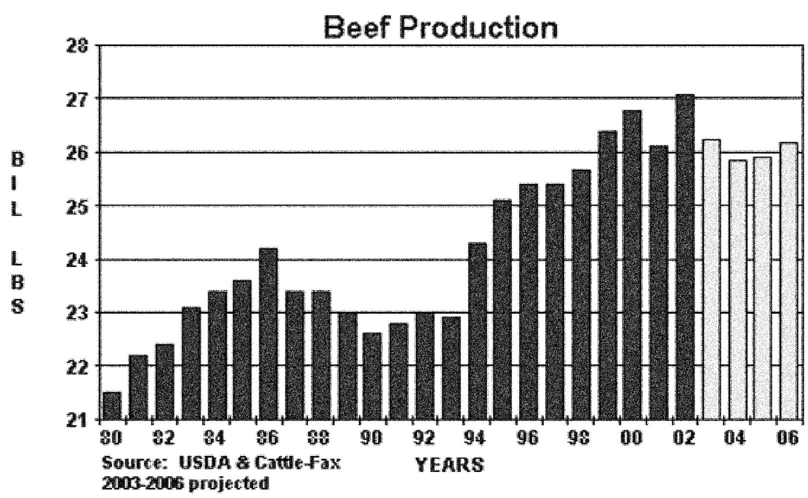
Industry Overview

Today's beef cattle operation is much different than that of our ancestors. Despite the fact that many of the fundamental aspects of raising cattle and producing beef, are the same as they were hundreds of years ago, the modern climate for conducting today's beef enterprise means that business structure and operating principals are often just as important to successful operations as the herd sire used.

The beef industry is the largest segment of agriculture in the United States with beef production taking place in every state. U.S. beef production is the largest segment of American agriculture and accounts for more than 27 percent of the United States' $100 billion agricultural economy. According to the USDA's Economic Research Service's Economic Trade Update, the U.S. beef industry exports $5.3 billion in beef and veal products and imports some $4.8 billion in live animals and beef products, making us a truly international industry.



Despite the decrease in the number of operations in our industry, overall productivity is increasing and continues to set record levels. That increase in productivity is the result of innovation and technology as well as producers that have found the need to prove that they are determined to make the changes necessary to be successful producers of beef.



Many modern ranchers operate as single proprietorships, much like other small businesses, as discussed later in our testimony, a great number do not. Additionally, many ranches that have reorganized their business structure in the past several decades have outgrown their original plans and are in much need of a business model that allows them to grow and prosper for years to come. For ranchers, like many in the small business community, modernizing their operations for the future or growing to meet new business opportunities mean that changes to the laws governing business structure will make that transition more profitable and increase the likelihood of success.

A growing number of agriculture operations are becoming involved in value added beef businesses or further processing ventures. Just ten years ago only a handful of alliance or certification programs even existed. Even fewer beef value added operations existed. Today there are dozens of successful alliance programs and a number of growing value added beef businesses that range in participation from a few to several hundred producers within the new business structure. Early ventures were structured as conventional or new generation cooperatives; however, changes in some state laws make it necessary for producers to look for other business structures to retain the ability to bring in outside capital or modern capital financing systems.

These new and promising business models are not without risk, and the cost of building a processing plant that may cost hundreds of millions of dollars can seldom be shouldered by a small number of producers, as permitted under current S corporation law. As an example, nearly 1,000 Iowa producers have pooled resources and committed some 200,000 head of cattle to their own processing facility with the hopes of creating additional profit for their producer owners. They will begin operations in their new facility by the end of the summer—but without the benefit of every possible business structure available to them and their members for establishing this creative enterprise.

Summary

Cattlemen seldom come to Congress with requests for assistance and we are one of the few in agriculture that operate without a "safety net" of price supports and subsidies. We much prefer that Congress take actions that allow us the ability to grow our business by creating a business environment that is prepared for today and tomorrow.

NCBA believes there are a number of actions this body can take which will help to do just that—create an environment that allows producers to create a business model that will work today and in the future. Economic Research Service reports that analyze the risk in production agriculture show that farm and operator risks are a primary factor that lenders evaluate when considering their relationship. NCBA believes that providing a wider range of workable and flexible options for producers in their business structure may be one of the most critical components in building a successful operation, both today and tomorrow.

H.R. 1896, the "Subchapter S modernization Act of 2003" and H.R. 1498, the "Small Business Opportunity and Growth Act of 2003" will significantly improve the environment that surrounds S corporations. H.R. 1498 specifically accomplishes many of the points that we discuss in our testimony. H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003" seems to be a strong step forward in allowing our capital providers the flexibility they need in today's world. Improved community and rural banks will strengthen the ability of all sizes and types of cattlemen to access capital markets.

Thousands of corporations, including farm and ranch corporations, have elected subchapter S status since President Eisenhower signed into law the Technical Amendments Act of 1958, which added subchapter S to the code. Although the legislative history makes clear that the purpose of subchapter S was to offer simplified tax rules for the small and family-owned business operating in the corporate form, S corporations have become a common form of business for larger producers as well.

Until the rise of the LLC in the mid 1990's the S corporation remained, for all practical purposes, the sole means for these producers to obtain the benefits of limited liability without the complex corporate tax. For many years, a change to another form of business was relatively easy. But by the time an alternative to the S corporation became widely available, this avenue had been foreclosed by changes to the tax code. Thus thousands of S corporations are saddled with the cumbersome and inflexible rules of the corporate form.

One of the most important decisions for the founder of a business is "choice of entity"—that is, whether to operate the business through a corporation, partnership, limited liability company or other form of business. This choice is plainly important for reaching business goals, and may be critical to the survival of the business. In today's business climate, the ability to adapt to changes in economic conditions is also becoming critical. For the family business, the choice is inseparable from the owner's preferences as to how the owner wants to relate to family co-owners. For all of these reasons, choice of entity is therefore potentially one of the most important aspects of business planning.

The law concerning choice of entity has changed enormously in the last fifteen years, particularly with the widespread adoption of laws authorizing the limited liability company (LLC). As a result, business owners have more flexibility in this area than ever before. Even so, older family businesses operated as S corporations may be "locked" into the corporate form, simply because of the tax cost of changing to another form. These businesses are thus unable to take advantage of the recent advancements in choice of entity. NCBA would propose to allow a one-time election for an S corporation to change to another form of business without incurring the normal tax cost of doing so.

Historical Perspective

Prior to the Tax Reform Act of 1986, a corporation could escape the corporate form by liquidating under Section 333 of the Internal Revenue Code of 1954. That section provided for nonrecognition of gain or loss (with limited exceptions) upon the complete liquidation of a domestic corporation within one calendar month. Limited recognition applied to previously untaxed earnings and profits, and distributions of cash and securities.

Utilizing Section 333, the shareholders of a corporation could liquidate the corporation and distribute the assets to the shareholders. The former shareholders could then contribute those assets to another corporation (or an entity taxed as a corporation) or to a partnership (or an entity taxed as a partnership) without recognition of gain or loss. As a practical matter, Section 333 was most useful to smaller corporations because of the requirement that all of the corporation's property be transferred within one calendar month.

Section 333 was repealed by the Tax Reform Act of 1986, and other corporate liquidation provisions were amended. Under the new regime, the shareholders of a liquidating corporation recognize gain or loss upon the liquidation as if there were a sale or exchange of the assets at fair market value. This is true even if the assets are immediately contributed to another business entity and the trade or business continues to be operated by the same owners without interruption. The tax cost can be especially high for businesses with valuable but depreciated plant and equipment and family farms with highly-appreciated agricultural land.

When the Tax Reform Act of 1986 was passed, the limited liability company was little known. Wyoming passed the first limited liability company enabling act in 1977. As members of this Committee are clearly aware, the entity closely resembles a partnership but its owners are protected from unlimited personal liability. Nevertheless, the Federal income tax characterization of the entity was uncertain. The fundamental issue for tax purposes was whether an unincorporated organization can be taxed as a partnership even though its owners are not personally liable for the organizations debts.

In 1982, the Internal Revenue Service formed a study group on LLC's. After six years, the group's work culminated in Revenue Ruling 88–76, 1988–2 C.B. 360. The ruling made clear that limited liability is not a per se barrier to partnership tax status. Interest in limited liability companies increased dramatically after the release of Revenue Ruling 88–76 and by 1996, all fifty states, the District of Columbia and Guam had enacted LLC statutes.

Revenue Ruling 88–76 had another effect. Once LLC's were in place and the IRS confirmed their tax characterization, state legislatures began experimenting with other partnership-like entities. The result has been an alphabet soup of limited liability partnerships and other entities of various kinds, most of them taxed as partnerships.

Consistent with Revenue Ruling 88–76, the Internal Revenue Service has taken the position that a general partnership may be converted into an LLC that is taxed as a partnership, generally without tax effects, Revenue Ruling 95–37, 1995–17 IRB 10. Indeed, it is now generally accepted that *any* entity taxed as a partnership may convert its form to another such entity, generally without tax effects.

The Internal Revenue Service has aided taxpayers in adapting to these changes—indeed has contributed to the accelerated pace of these changes—by promulgating the so called "check the box" classification regime. Effective January 1, 1997, each domestic entity (other than one organized pursuant to a corporate or joint stock statute) determines its own tax status simply by checking or not checking a box. Furthermore, unless an unincorporated organization elects otherwise, it will be taxed as a partnership, 26 C.F.R. § 301.7701–3.

Under these regulations, the tax status of an unincorporated organization no longer depends on any analysis of the organization's structure or the legal rights of the owners. With tax classification constraints removed, LLC varieties have and will continue to proliferate. Governance structures will be custom-designed for the needs of the owners, with great flexibility for the rights and roles of LLC members in the organization.

Recommended Changes

The sea change in choice of entity law has provided little value to owners of S corporations. Because of changes to the Internal Revenue Code made by the Tax Reform Act of 1986, a corporation may not convert to an LLC without all the tax effects of liquidation. This is particularly unfortunate for S corporations, which are already taxed in a manner very similar to partnerships and which are typically used for small and family-owned businesses. Partnerships and entities taxed as partnerships have been able to take advantage of the latest developments in this area of the law, generally without adverse tax effects, while S corporations remain saddled with the cumbersome and inflexible corporate form of business.

An S corporation and its shareholders could benefit from a one-time window of time within which to convert to an LLC or some other entity taxed as a partnership, but without incurring the tax cost of liquidation. The general outlines of such a proposal would be as follows:

- The proposal is limited to S corporations because those already having elected S status are most likely to utilize and benefit from a change to the LLC form.
- Because state laws vary, the mechanics of a conversion should not be determinative. Thus a conversion could be accomplished through liquidation of the S corporation and contribution to the LLC or (where allowed by local law) by merger or consolidation with the LLC (or other new entity).
- A limited period of time should be available to make the conversion.
- Consistency rules should be adopted to govern basis of both the assets and the owners' interests in the company, as well as holding periods of the assets and interests.
- The S corporation and its shareholders should be required to file an election with the timely-filed tax return for the period in which the conversion takes place.
- To limit the use of the technique for other tax planning purposes, the proposal suggests requiring (a) that all, or substantially all, of the assets of the S corporation be transferred to the new entity, and (b) the shareholders of the S corporation own at least 80 percent of the new entity (or an analogous continuity of ownership rule).
- Anti-abuse rules should be included to prevent use of the conversion solely to avoid the tax effects of an anticipated corporate liquidation. Such rules could require, for example, the continued operation of the trade or business in the LLC form for a certain period of time. The failure to meet this requirement would result in the imposition on the shareholders of a recapture tax equivalent to the tax due had the corporation been liquidated.

Closing

The Internal Revenue Code itself reflects a policy of respecting economic reality over form in the conduct of a trade or business. For example, section 1031, which existed even in the 1939 code, allows nonrecognition of gain or loss in the exchange of property used in a trade or business, or for investment, on the theory that the taxpayer has not cashed out his investment. Code Sections 351 and 721 allow nonrecognition on the contribution of property to a corporation or a partnership, on the rationale that the taxpayer is only changing the form of his investment.

The S election itself was a giant stride in removing tax considerations in choice of entity. More recently, the Internal Revenue Service has done much to remove tax considerations from the choice of business form through the check the box regulations. The Service should be commended for taking this step.

The next step in the process is allowing those S corporations that can more efficiently function as an LLC the one-time chance to make the conversion, without tax cost being the controlling factor. Until these conversions can be accomplished, the task of reducing the role of taxes in choosing a business form or in adapting to changing economic conditions will remain unfinished.

The NCBA is grateful to the Subcommittee for the opportunity to share our views on this important issue.

Chairman MCCRERY. Thank you, Mr. True.

Mr. Alexander, Subchapter S, as you pointed out, was first enacted back in the fifties and has since been modernized, so to speak, a couple of times, the most recent being in 1996. Can you give us some idea of how the business environment has evolved over time which would call for further modernization of Subchapter S rules?

Mr. ALEXANDER. I will try to, Mr. Chairman. Yes, it was effective January 1, 1958. That was one of my better years. At first, it seemingly worked pretty well, but then people discovered, after they elected Subchapter S, two things. Number one, they were locked in; and number two, because of changes in their businesses or additional needs of their businesses or growth of their businesses, some of the restrictions placed in Subchapter S by those who drafted it—and they were trying hard to put together a simple pass-through system—made it very difficult to grow their businesses under Subchapter S restrictions.

One of those restrictions, of course, was the number of stockholders, which grew from 10 in 1958 to 75 today—and clearly ought to grow further, with the suggestions that have been made in the bills that you are reviewing today. Another one was mezzanine capital, the need for it, and the fact that Subchapter S makes it extremely difficult to provide the capital necessary for the growth of a business that might not have been anticipated when the business first elected.

The last witness mentioned the possibility of moving from Subchapter S to a limited liability form or other form—which weren't permissible back in those antediluvian years when I was working for the IRS—and, by making use of some very liberal Department of the Treasury regulations, check the box to decide on the business entity. That is great, to be able to move out, but right now under current law you are locked in. You are locked in to the election that you made years ago. You have to go through the devices that I mentioned in order to do something essential to the continuation and the growth of the business. Those restrictions, as Ms. Olson stated when she was in the private bar, should be lifted, because lifting them simplifies, not complicates, the law.

Chairman MCCRERY. So, should I infer from your comments—you have said a couple of times now that somebody from the Department of the Treasury, before they were in the Department of the Treasury, said something different from what they are saying now. So, should I infer that you think the Department of the Treasury has got blinders on, and they are just thinking about revenue loss and not really thinking about what is best for business structure and business decisions?

Mr. ALEXANDER. No, I think in good faith—and they are fine people—they are more concerned about somehow preserving an apparently simple system for simple people to do simple things under. Business doesn't work that way.

I would hope that, even though I know that when you go into government, you do tend to have a different attitude—maybe the attitude you had before—that nevertheless we ought to try to do something useful for the 2.5 million or so small businesses that right now are caught unless some manner of escape is written. Now we don't have one.

Chairman MCCRERY. Thank you. Mr. Zarzar, can you describe for us some of the traps that are out there for the unwary that have Subchapter S and can catch small businesses?

Mr. ZARZAR. Mr. Chairman, certainly I would say first as a threshold matter that the S corporation regime is not as complex as some others. So, that is fortunate. Nevertheless, as you ask, there are some of those both with respect to the eligibility of use of Subchapter S and as to the issues of basis limitation and the like.

What I would like to do, after noting that indeed the legislation does seem to take care of all these, I guess I would ask my colleague, Ms. MacDonough, to speak to some of those more esoteric technical details, if you would.

Chairman MCCRERY. Sure.

Ms. MACDONOUGH. I think that the bill goes a long way in eliminating many of the traps for the unwary. In particular, the changes to the ESBT rules are very favorable; I think that that is a major hurdle. The rules relating to bank-to-bank loans is probably one of the most significant traps. It is probably the most litigated area in Subchapter S. I think that, for whatever reason, the courts and the IRS have taken a very harsh view on the ability of closely held businesses to restructure their finances in order to create basis. So, that is a very, very important provision.

The step transaction doctrine and the application of that upon electing QSub status is really a trap for the unwary, especially small businesses that would restructure related entities and not have the advantage of tax advisors who are going to warn them that they may be triggering tax as a result of that. The sale of a partial interest in a QSub would also be a trap for somebody who is not being properly advised. Interestingly, the regulations with respect to QSubs specifically point out a planning technique to get around that particular trap, but unless you are advised by a tax advisor who is familiar with those regulations, that would be something very easy to miss.

Overall, we think that Subchapter S is simple, that that is one of the major advantages of it, and that the provisions—and this legislation goes really, really a long way in eliminating many of the traps. So, we are very much in favor of these provisions.

Chairman MCCRERY. Thank you very much. I have some more questions, but I am going to pause now and give my colleague, Ms. Tubbs Jones, an opportunity to inquire of witnesses. Ms. Tubbs Jones.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Mr. Alexander, you took the Ohio bar in 1954. Were you living in Ohio at the time, or had business, or what?

Mr. ALEXANDER. Yes, ma'am. I was living in Cincinnati, which is a great city in a great State.

Ms. TUBBS JONES. Well, thank you. I am from Cleveland.

Mr. ALEXANDER. Right. I knew you were.

Ms. TUBBS JONES. Okay. Let me ask you, when I first came to Congress, I was serving on the Committee on Financial Services. We were debating financial modernization—H.R. 10, financial modernization. One of the questions I ask is—really, what we are about to do is to allow people to do legally what they have been doing by way of legal fiction already.

In essence, are you suggesting in your commentary about having—I made a note of this—"rigidity that does not promote simplicity"—that really people have been able to use legal fictions to address some of the issues; that we ought to be able to straight-out allow them to do what they need to do to make their businesses successful?

That was a long question. I apologize for that. In essence, what I am trying to find out from you is, do you think that these changes need to be made in order for small or S corporations to be able to do better business?

Mr. ALEXANDER. Absolutely. Do better business if they didn't have to try to get around these rigid rules. As both the AICPA witness and I have testified, if you have to look in the regulations to find a way to get around the rules, that means you have to hire lawyers, and that means you have to spend money on lawyers rather than on the business.

Ms. TUBBS JONES. Are there any other suggestions that are not included in this legislation that you think would help S corporations?

Mr. ALEXANDER. We have talked about two types of legislation today: One, the fixing-it-up type, as exemplified by the Mr. Shaw and Mr. McInnis bill; and two, the "Hey, let them out without making it impossible for them to get out," bill which is Mr. Houghton's bill. Those might go hand-in-hand, but if you didn't do the first one, there is going to be a huge need to do the second. The problem with that is that some people, some businesses cannot conduct themselves in this partnership mode—tax nirvana, as it is called. Banks on the reserve method can't; some construction companies and other companies can't. I guess a cattle ranch in Wyoming could. It would be great to do that.

They have a problem. Even if they were let out without a punitive inside-outside tax, which is the rule now, you couldn't get out because you couldn't conduct your business because of other laws, State laws, and other rules.

Ms. TUBBS JONES. Thank you. Either of the CPAs——

Mr. ZARZAR. We will figure that one out.

Ms. TUBBS JONES. Okay. We have gone through—again, from my experience on the Committee on Financial Services, the Enrons, the Global Crossings, and on and on and on and on and on, and a whole discussion about responsibilities of CPAs and auditors and accountants and so forth. In the S corporation world, are there issues that people should be paying attention to with regard to accounting that should come to our attention? I am not trying to be an investigative reporter, I am just curious as I sit here and am responsible for making policy.

Ms. MACDONOUGH. I think in our written testimony we did address some areas of concern with the legislation, where we felt that there would be opportunities for manipulation, and we would be happy to discuss those with you at greater length. There are also some areas that we did not have the opportunity to address in our written testimony that we would like to supplement, because we are aware of not a lot——

Ms. TUBBS JONES. Give me an example, because I haven't had a chance to read all that material.

Ms. MACDONOUGH. I will give you an example of something that is not in the written testimony that is being used as a planning idea, and it relates to the deductibility of State income taxes. There is a position that if an S corporation makes composite payments of taxes on behalf of its shareholders, that under a special rule under 164, that allows a corporation to claim a deduction for taxes that are paid as a result of a shareholder owning stock, that the corporation claims that deduction. So, some people are encouraging S corporations to make composite payments, have the S corporation claim the deduction, and by doing that you are taking that as a trade or business deduction and not subject to the limitations on itemized deductions, and not a preference for the alternative minimum tax.

There are technical problems with that position, but nevertheless there are firms that are advocating that. So, that would be an example of something we would like to recommend that you clarify as you move forward.

Chairman MCCRERY. Thank you, Ms. Tubbs Jones. I am going to ask a few more questions and then I would invite you to further inquire if you so desire. Mr. Zarzar, this question has to do with the tax bill that the President just signed.

Mr. ZARZAR. Yes.

Chairman MCCRERY. It concerns the passive income limitations in section 1375. Those provisions only affect C corporations that have converted to S corporations. Is that right?

Mr. ZARZAR. That is correct, Mr. Chairman.

Chairman MCCRERY. It is my understanding that the policy behind the passive income limitations in section 1375 is to mirror the personal holding company rules in Subchapter C. Thus a C corporation could not avoid the personal holding company rules merely by converting to Subchapter S status.

Mr. ZARZAR. Also correct, sir.

Chairman MCCRERY. Now, in the tax bill the President just signed, we reduced the rates on dividends distributed by C corporations to 15 percent. The new law also lowers the rates on personal holding companies from 35 percent to 15 percent. Did we lower the rates under section 1375?

Mr. ZARZAR. The rate under section 1375 was not lowered, Mr. Chairman.

Chairman MCCRERY. If we intended the passive income limitations in section 1375 to mirror the personal holding company rules, shouldn't the rate in section 1375 be lowered?

Mr. ZARZAR. I would argue absolutely it should be, Mr. Chairman, yes.

Chairman MCCRERY. Thank you. Now, Mr. Cloutier, prior to 1997, banks were not allowed to be S corporations, is that right?

Mr. CLOUTIER. That is correct, Mr. Chairman.

Chairman MCCRERY. As C corporations, it was common for stock in a bank to be held in an IRA. Is that correct?

Mr. CLOUTIER. That is correct, yes, Mr. Chairman.

Chairman MCCRERY. Can IRAs own S corporation stock?

Mr. CLOUTIER. Not at this time.

Chairman MCCRERY. So, many banks that would prefer to become S corporations couldn't do so because of that restriction. Is that right?

Mr. CLOUTIER. My bank is an example of that.

Chairman MCCRERY. In your opinion, would more banks consider switching to S corporation status if this restriction were removed?

Mr. CLOUTIER. I can tell you that I have done a number of State conventions—I just came from Ohio not long ago—and that is the number one question asked by community bankers: Can we get it expanded? Can we get IRAs in it? A lot of opportunity have their stock in IRAs in banks, and they didn't know the law was going to change in 1996. That is what we are proposing, is that we go back and grandfather those people to allow them to switch.

We think it is also the same thing, when we look at the directors' shares that I mentioned. We are the most highly regulated industry in America. We think on all of these things—passive income, director shares—that we certainly should follow the rules as set out by the OCC and the Federal Deposit Insurance Corp. (FDIC). I found it kind of interesting that the Department of the Treasury, which the OCC is a part of, says no, you can't do this with Subchapter S, but yet the OCC says no, you can't do away with them either.

I really appreciate it, Mr. Chairman, you asking them to get together to try to work this out, because we are just a highly regulated industry. We wouldn't want one regulator telling us we can't do something, and it would affect our shareholder value. So, we appreciate that a great deal. Thank you, sir.

Chairman MCCRERY. You are quite welcome. Let us hope we get some results. Also concerning regulations, isn't it so that regulators require banks to have invested assets to maintain adequate liquidity for safety and soundness purposes?

Mr. CLOUTIER. Absolutely, yes, sir.

Chairman MCCRERY. Depending on a bank's loan demand, they may invest funds in government securities which generate passive income?

Mr. CLOUTIER. That is absolutely correct, Chairman. Once again, a lot of those rules are set up, as I know you all are well aware of, by the regulatory agencies, the FDIC, the OCC, and so forth. We think, personally, sometimes it is a little unfair for them to say, well, you can do this, but the regulators tell us you must do this. So, we would like to have that rule clarified, if we could. We think it is only fair.

Chairman MCCRERY. Mr. True, I take it the gist of your testimony—tell me if I am wrong—but it seems to me the gist of your testimony is that you are being punished merely because of the timing of your selection of organization for your business. You chose that organization before the LLC was in existence. So, you were already an S corporation. Now all of a sudden there is this new form that is out there available to new businesses, but you can't opt for that new form because you are stuck in a Subchapter S. Is that the gist of what you are telling us.

Mr. TRUE. Yes, Mr. Chairman. Our family businesses were started back in the late forties by my mother and father. Since that time, my two brothers and I have assumed the responsibility of running those businesses. Each operation that we have—and that was the point of trying to mention them in my testimony—each operation that we have is set up by its own entity. Some of those entities go back to literally the early fifties, and S corporation elections were chosen early in the operations of those entities. As you indicated a minute ago, those early-on elections and the S corporation laws have helped our family through the years. With the new development of other law in this choice of entity arena, we feel that we need the flexibility to choose not only new entity forms, but also to choose entity forms for ongoing operations.

Chairman MCCRERY. Fine. Well, thank you very much. Ms. Tubbs Jones, would you like to follow up?

Ms. TUBBS JONES. Thank you, Mr. Chairman. To Mr. Cloutier.

Mr. CLOUTIER. Yes, ma'am.

Ms. TUBBS JONES. Okay. The FDIC recently adopted a final rule granting deposit insurance to a State bank chartered as a LLC. If the remaining restrictions on the establishment of bank LLCs are removed, would the number of banks that would be organized as LLCs likely dwarf the number of Subchapter S banks, or the other way around? Or neither?

Mr. CLOUTIER. That would be hard to tell, Ms. Jones, because—the reason being is that each regulatory agency—as you said, the FDIC has just released the rules. You have to remember we also have to deal with the Federal Reserve and, in my case, the OCC. I am a national bank. So, I think we would have to look at it and study it and make determinations as to which one would be more effective for us.

Many of the small community banks are looking for a way to do that, and LLCs might end up being better if we are allowed to do them, but once again, we have to read through all the regulations—having served on the House Committee on Financial Services, I know you know how much that can be—and certainly visit with our accountants and our attorneys. I think a lot of banks would look at it very hard—I would be honest with you—because they want an avenue that would help them continue to serve their communities. A Subchapter C, Subchapter S, and LLC are giving them a better opportunity to do that.

Ms. TUBBS JONES. Let's go to the accountants. What would the motivation be to someone taking a look at whether the LLC would be a better vehicle, or stay in Subchapter S with that change?

Ms. MACDONOUGH. I think that it depends on whether you are looking from an organization perspective or from a business perspective or from a tax perspective. From a business perspective, there really is not a tax issue with taking an existing corporation and moving to LLC form. It would require that you check the box to tax it as a corporation, but if, from a business perspective, you want to operate it as an LLC, current law accommodates that without a problem.

In terms of an existing business, you are generally going to operate under Subchapter S, versus Subchapter K, if you previously operated as a corporation because of the problem that Mr. True pointed out, which is that you can't convert from a corporation to a partnership without incurring corporate-level taxes, while the shareholder-level taxes are resolved at the liquidation.

From making the decision for a new entity, I would say that a lot of people use LLCs because they are more flexible. However, there are still advantages to Subchapter S, its simplicity being one of the advantages, and then there are also payroll tax advantages and advantages from a State tax perspective.

Ms. TUBBS JONES. Mr. Cloutier, one last question for you. What else would the community bankers like to see this Committee address if there were other things we could address in any of the bills that are being presented right now?

Mr. CLOUTIER. Well, as I mentioned, the real key points to us is increasing the number to 150. I could not tell you, Congresswoman, how many bankers have come to me and said if this would be increased, I would really consider it.

Straightening out the directors' share issue. Once again, this is a regulatory problem. It is not the banks wanting to do this, it is the regulators telling us we must do it.

Then, of course, as I have talked about, we really want to see IRAs grandfathered to where we can be able to do that. Also, in a lot of our banks, the ESOPs own a lot of banks. These are really community institutions.

So, we think those things would be important, and we think these are excellent bills, and we support them very strongly. Thank you all very much for having this hearing.

Ms. TUBBS JONES. Mr. True, I don't have a question, but I would love to give you a couple of minutes to tell me whatever you want to tell me. Within limits.

Mr. TRUE. Thank you very much, Congresswoman. I appreciate the opportunity. We feel—our family has been in business for over 50 years, as I indicated earlier.

Ms. TUBBS JONES. I do have a question. Are all of these businesses that you are telling me about S corporations?

Mr. TRUE. No, we have—actually, we operate in different forms in different operations for different reasons. As I indicated, certainly some of them are tax-related. Others are liability-limiting reasons. Part of them are regulatory reasons. Up until 1997, we operated our community bank as a C corporation because of regulatory demands. Once we had the opportunity to move to an S corporation with our community bank, we took that opportunity at that time.

So, we also have operations that are currently S corporations, we have several operations that are currently all C corporations, and we have a couple that are general partnerships just within our own organization.

The point I wanted to demonstrate is we need the flexibility, we would like the flexibility to be able to choose the entity form that we feel is best for our ongoing operation and our family and our 800 employees based on non-tax issues. We want to be able to make those decisions in a tax-free environment, if you will, and not allowing tax to be the driver in deciding the type of entity that we have to select. Thank you.

Ms. TUBBS JONES. Thank you, Mr. Chairman.

Chairman MCCRERY. I want to thank all the witnesses today for coming and sharing with us your views on Subchapter S reform, and also thank you for being patient as we worked through our legislative schedule today.

With that, this hearing is adjourned.

[Whereupon, at 3:02 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Credit Union National Association, Inc.

The Credit Union National Association (CUNA) is pleased to provide comments for the record in connection with the June 19, 2003 hearing of the Select Revenue Measures Subcommittee of the House Committee on Ways and Means on "S Corporation Reforms" and commends Chairman Jim McCrery (R–LA) and Ranking Member Michael McNulty (D–NY) for their insightful leadership in holding these hearings.

CUNA represents over 90 percent of the nation's approximately 10,400 state and federally chartered credit unions and their 83 million members.

Subchapter S of the Internal Revenue Code was first enacted in 1958 to reduce the impact of federal taxation on small business corporations' choice of business structure and to eliminate the corporate level of tax for such entities. Banks were first allowed to elect Subchapter S status in the Small Business Job Protection Act of 1996. Since that time approximately 1,900 banks have elected Subchapter S status.

The proposed legislation, H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," introduced by Representative Scott McInnis (R–CO); H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," introduced by Representative Jim Ramstad; and H.R. 1896, the "Subchapter S Modernization Act of 2003," introduced by Representative E. Clay Shaw, Jr., (R–FL), would significantly expand and enhance Subchapter S benefits for the banking industry. In this connection, we note the industry's longstanding lobbying effort to enact such S Corporation legislation.[1] Incongruously, while aggressively lobbying to increase the tax advantages of Subchapter S for banks, the banking industry also continues to actively lobby to impose additional taxes on credit unions,[2] arguing that credit unions' income tax status provides a competitive advantage and that imposing additional taxes would "level the playing field."

In introducing the Senate version of the "Small Business and Financial Institutions Tax Relief Act of 2003", S. 850, Senator Wayne Allard (R–CO) said he would rather level the playing field by reducing taxes and regulation on other financial institutions. To that end, he reintroduced legislation that would raise the maximum allowable number of S corporation shareholders and thus make it easier for banks to switch to tax-advantaged S corporation status. He observed that his bill would "reduce the tax burden on community banks by permitting the smaller institutions to more easily convert to small-business corporations known as Subchapter S corporations." He also said "Some voices are calling for the taxation of credit unions. I oppose it. Credit unions are not-for-profit businesses and should not be taxed."[3]

CUNA has no objection to financial institutions reducing their tax burden and believes any savings should be passed along to customers. However, we feel compelled to point out the duplicity of the banking industry position. Recent attempts in at least six states to impose additional taxes on credit unions focus on budget deficits and the revenue cost of the credit union income tax exemption. By contrast, CUNA estimates that the direct cost to the U.S. Treasury of the elimination of double taxation under bank Subchapter S election amounted to a record $593 million in foregone taxes in 2001 and $2.1 billion over the past five years. These figures are adjusted for the fact that Subchapter S bank shareholders receive higher dividends (and consequently pay more taxes) than they would if their institutions had not opted for formation under Subchapter S.

If recent growth rates continue, the total foregone tax revenue due to Subchapter S election by banks will amount to approximately $13.5 billion over the next 10

[1] Subchapter S bank legislation was first introduced in the 106th Congress, *The Small Business and Financial Institutions Tax Relief Act of 1999,* H.R. 1638, and 1994, by Representatives Scott McInnis (R–CO), Jim McCrery (R–LA) and J.D. Hayworth (R–AZ), and S. 875, by Senator Wayne Allard (R–CO).

[2] Most recently State bank associations have initiated a coordinated lobbying effort to impose additional taxes on state chartered credit unions. See, e.g., California State Bills AB 1226 and SB 901; Iowa State Bills HF 388, SF 242 and HSB 293; New Mexico State Bill HM 29; Oregon State Bill HB 3491; and Utah State Bill 162.

[3] Credit unions are not-for-profit financial cooperatives, serving members who share something in common: employment, association membership, or residence in a particular geographic area. Members elect credit union boards of directors; each member has an equal vote, regardless of how much he or she has on deposit. Only members may serve as directors, and the vast majority of directors serve without remuneration. Presently, more than 129,000 Americans volunteer for their credit unions. More than 82 million U.S. consumers are member-owners of, and receive all or part of their financial services from the nation's 10,120 credit unions. Of these, 17% rely on credit unions for all of their financial services; 36%, while also using other financial institutions, primarily use credit unions; and 47% are credit union members who primarily use other financial institutions. (Source: Federal Reserve *Survey of Consumer Finances, 1998*).

years. By 2006, the annual foregone tax revenue from Sub S banks will exceed the foregone revenue from the credit union tax treatment.

Further, a detailed examination of Subchapter S bank financial results for 2001 shows that these banks charged depositor fees that were a bit higher than the fees charged by other small (and some large) banks. At the same time they recorded earnings (ROA) that ranged as much as two times higher than peer commercial banks. For example, the Subchapter S bank average ROA was 1.69% for the year while non-Subchapter S banks with less than $100 million in assets earned 0.79% and non-subchapter S banks with less than $1 billion in assets earned 1.05%. Subchapter S bank cash dividends as a percent of assets averaged as much as 2.5 times higher than those at peer banks.

Recent statements by banking industry lobbyists made in connection with the President's dividend proposal suggest that the primary motivation for industry efforts in expanding Subchapter S is maximizing the amount of dividends to be paid to shareholders (and not to generate more competitive rates and lower fees for customers).[4] These comments tend to belie the earlier claims that the bankers are disadvantaged in providing quality lower cost services to their customers. We believe any such savings should be passed along to customers in the form of more competitive rates and fees. So, while the bankers complain that credit union tax status deprives them of a level playing field, the evidence suggests that a major reason for their competitive issues lies with their failure to pass their tax savings along to their customers in the form of more competitive pricing.

Finally, we note that the banking industry is aggressively pursuing additional tax advantages. H.R.1375, the "Financial Services Regulatory Relief Act of 2003" contains provisions that would permit the Comptroller of the Currency to issue regulations or orders permitting individual directors of national banks that are S corporations to hold subordinated debt of the bank in the amount of $1,000 or more in lieu of stock in the corporation.[5] The bill also would authorize the Comptroller of the Currency to prescribe regulations that would allow national banks to organize as limited liability companies (LLCs).[6] In this connection, the Federal Deposit Insurance Corporation (FDIC) has recently adopted a final rule granting deposit insurance to a State bank chartered as a limited liability company (LLC). The Internal Revenue Service has not yet authorized bank LLCs. However, if the remaining restrictions on the establishment of Bank-LLCs are removed, the number of banks that would be organized as LLCs could dwarf the number of Subchapter S banks—and banks would reap even greater tax benefits that the substantial ones already afforded under current law.

We commend your efforts to reduce taxation of financial institutions and to promote increased savings. We recommend that Congress monitor these tax-advantaged banks to determine the amount of advantage passed along to customers in the form of more competitive rates and fees. Thank you for considering our views.

Statement of Employee-Owned S Corporations of America

<u>Background</u>

Employee-Owned S Corporations of America (ESCA) is the only organization that speaks exclusively for America's private, employee-owned businesses on the issue of pension and retirement savings. Thousands of non-public companies across America are employee-owned. These companies, the vast majority of which are small- and

[4] In this connection, several bankers and the American Bankers Association's Senior Tax Counsel and Director of the group's center for community bank tax indicated banks would be less inclined to pursue S-Corporation status and that banks and thrifts that currently have it might convert back to a typical corporate structure if the President's original dividend proposal had become law. "The primary motivation for electing Subchapter S is to avoid taxation at the corporate level, but this gets rid of it at the individual level. I think if this passes bankers will be saying—Why deal with the ridiculousness of the subchapter S laws?" *American Banker*, p.1, *January 14, 2003*. Interestingly, in a later Letter to the Editor, a tax attorney-commentator observed the article "left the impression that banks should reconsider whether S status is preferable to C status." The attorney pointed out that even if the President's dividend tax proposal were enacted "The well-informed thoughtful decision will be to remain an S corporation or make an S election as soon as possible. The benefits of being taxed as an S corporation far outweigh the disadvantages." He then enumerated eight such benefits. *American Banker, January 17, 2003*.

[5] Section 101, National Bank Directors.

[6] Section 110, Business Organization Flexibility for National Banks.

medium-sized and/or family businesses, are a hallmark of American entrepreneurship.

Today, ESCA companies operate in virtually every state in the nation, in industries ranging from groceries to general contracting, pizza parlors to printing, health care supplies to heavy manufacturing. Through their ESOP-owned structures, ESCA businesses around the nation provide their employee-owners with substantial retirement benefits through ownership of the businesses where they work. Millions of employees have amassed substantial retirement savings and retired early as a result of owning shares of their company. Employees want to own company stock in their retirement plans knowing that their hard work results in easily measurable cash benefits to them.

Current law makes it difficult for S corporation ESOPs to repay debt incurred to purchase employer stock and limits the retirement savings of employee-owners

ESOPs are a wonderful way to help employees build a retirement nest egg, but current law restricts the ability of ESOPs sponsored by S corporations to repay debt incurred to purchase employer stock. In this regard, current law is at odds with the economic interests of the employees who participate in S corporation ESOPs.

As this Committee is aware, the Internal Revenue Code generally prohibits loans or guarantees between a tax-qualified plan and a corporation that sponsors the plan (a "prohibited transaction"). IRC Sec. 4975(d)(3), however, provides an exemption for loans that fund the purchase of employer stock if the loan is primarily for the benefit of plan participants and their beneficiaries and the ESOP provides no collateral for the loan other than employer securities ("exempt loans").

The Internal Revenue Service has taken the position in private letter rulings that Treasury Regulations under IRC Sec. 4975(d)(3) do not allow an ESOP to repay an exempt loan with distributions on shares of S corporation stock that have been allocated to the accounts of plan participants and do not serve as collateral for the loan. IRC Sec. 404(k)(5)(B) allows an ESOP to use "dividends" received with respect to shares of employer stock to make payments on an exempt loan, regardless of whether such shares have been allocated to the accounts of participants and are no longer pledged as collateral to secure the loan. This provision, however, does not apply to distributions by S corporations because they technically are not "dividends" for federal income tax purposes. Thus, S corporation ESOPs are precluded from repaying exempt loans with distributions on S corporation stock that has been allocated to the accounts of participants, even though a comparable distribution from a C corporation could be so used.

Current law hurts S corporation ESOPs and their employee participants

In current economic conditions, so many of America's S corporations find themselves hard-pressed to survive and prosper. Moreover, with S corporation businesses so heavily concentrated in manufacturing—a sector that has been particularly hard-hit by the national economic downturn—this situation is all the more severe. ESCA applauds the Subcommittee's desire to identify what steps can be taken to enhance S corporations' access to capital markets and their economic well-being.

It should come as no surprise to Committee members that today's economy leaves S corporation ESOPs with limited options for servicing debt. Restrictions such as the one described here—which stand in stark contrast to the policy underpinnings of IRC Sec. 404(k)(5)(B) to facilitate the payment of ESOP loans and promote employee ownership—make the current situation worse. By limiting the debt repayment options of S corporation ESOPs, these restrictions limit the ability of ESOP-owned S corporations to reinvest earnings in the business and bolster the value of the retirement savings of their employee-owners.

Beneficial legislation has previously been introduced

In the 107th Congress, legislation was introduced in the House and Senate—H.R. 1896 and S. 1201—to modernize the rules governing S corporation businesses. Included in both those measures was a provision that would treat distributions received by an ESOP with respect to S corporation stock as a dividend for purposes of IRC Sec. 404(k)(5)(B). This legislation would address the challenge that leveraged S corporation ESOPs currently face by allowing distributions with respect to both allocated and unallocated shares of S corporation stock to be used to repay exempt loans, thereby providing equal treatment for S corporation ESOPs and C corporation ESOPs.

ESCA's members urge the Subcommittee and its leadership to seek out opportunities to advance a similar measure in this Congress, particularly to the extent that Subchapter S reforms may be included in broader tax legislation this year.

Conclusion

ESCA looks forward to continuing to work with the Subcommittee to promote the advancement of a provision that would enhance the ability of S corporation ESOPs to repay debt incurred to purchase employer stock. During such challenging economic times, such a measure is particularly critical.

On behalf of the employee-owners of all our ESCA companies, we thank the Subcommittee for its time and its effort to identify opportunities like this one to improve the current rules governing—and in this case, limiting—the ability of ESOP-owned S corporations to thrive, grow and generate retirement benefits for their employees. Thank you.

Statement of J. Michael Keeling, ESOP Association

On behalf of The ESOP Association and its nearly 1300 members representing all 50 states, I thank you for the opportunity to have our statement on H.R 1896, the Subchapter S Modernization Act, included in the official record of the Subcommittee on Select Revenue Measures for the House Committee on Ways and Means' hearing record from the June 19, 2003 hearing, "S Corporation Reform." Of these 1300 companies, approximately 900 are S Corporations sponsoring ESOPs.

The ESOP Association is a 501(c)(6) advocacy and educational entity that has interacted with the Committee on Ways and Means since the Association's beginnings in 1978 on various tax issues pertaining to this nation's policies related to stock ownership by employees in the companies where they work. These policies are dominated by the ownership and retirement savings structure known as the employee stock ownership plan, or ESOP.

This statement will address The ESOP Association's support for H.R. 1896, the Subchapter S Modernization Act, and, more specifically, the Association's firm endorsement of Section 604, "Distribution to an Employee Stock Ownership Plan."

Since 1997, when Congress first enacted laws permitting S Corporations to sponsor ESOPs, the employee ownership community has been diligent in its fight to preserve and maintain laws and regulations that help create and maintain broad-based employee stock ownership among S Corporations. The Association has also worked aggressively to advocate for more fair treatment in S corporations in certain instances, because as is typical in drafting new law, overlooked aspects of how the law will emerge after initial Congressional action and impact the real world.

Passage of H.R. 1896 would permit S Corporation ESOP companies to operate within a network of fewer constraints and less complications.

Similarly, inclusion of Section 604, "Distributions by an S Corporation to an Employee Stock Ownership Plan," would greatly expand the appeal for an S Corporation to sponsor an ESOP by removing some of the unintended restrictions on creation and operation of S corporation ESOPs, particularly when the ESOP holds less than 50% of the stock, that often deter ESOP companies from converting to S status, or S Corporations from implementing ESOPs. These restrictions generally provide benefits to S Corporations by putting S Corporation shareholders on a level playing field with C Corporation shareholders.

Again, we thank the Subcommittee for permitting our written statement to be included in the official record of the hearing entitled, "S Corporation Reform."

Statement of the Honorable Scott McInnis, a Representative in Congress from the State of Colorado

I would like to begin by thanking Chairman McCrery, Ranking Member McNulty and the Select Revenue Measures Subcommittee for holding this hearing today on subchapter S corporation reforms. The hearing is timely, and I welcome the chance to discuss these issues as a strong proponent of reforming and simplifying the many complexities inherent in subchapter S.

For the last three Congresses, including the 108th Congress, I have introduced legislation designed to simplify and reform subchapter S corporation tax laws. My legislation includes both broadly applicable reform proposals and several proposals focused on enhancing the ability of community banks to convert to and operate as a subchapter S corporation.

My legislation, the Small Business and Financial Institutions Tax Relief Act of 2003 (H.R. 714), is designed to help ease the tax burden on thousands of small businesses and community banks. This bill targets the businesses that drive growth in the communities they serve, and assists small businesses and community banks which have already chosen to operate as subchapter S corporations. These provisions *would spur economic growth* by enabling small businesses organized as subchapter S corporations to add shareholders, simplifying complex tax rules for these small businesses, and reducing barriers to enable community banks to convert and operate as subchapter S corporations.

My bill expands subchapter S eligibility, enabling small businesses to raise capital—which is immediately invested into the business and the community. It also addresses impediments to community banks that seek better tax treatment. When Congress passed the Small Business Job Protection Act of 1996, it made community banks eligible to elect subchapter S corporation status for the first time in tax year 1997. Unfortunately, because of the complicated interplay between banking and tax laws, many community banks encounter significant barriers to qualifying under the current rules and cannot benefit from Congress' intended tax relief. My bill would correct many obstacles that often prevent community banks from converting to subchapter S.

Key features of the Small Business and Financial Institutions Tax Relief Act of 2003 include increasing the number of subchapter S corporation eligible shareholders to 150 from 75; permitting S corporation shares to be held in Individual Retirement Accounts; clarifying that interest on bank investment held for liquidity and safety and soundness purposes will not be included as restricted passive income; and clarifying the treatment of directors shares, which banks are required to issue under certain banking laws and rules.

The measures in H.R. 714, designed to provide tax relief and an economic boost to small businesses organized as subchapter S corporations, have additional significance because *small businesses produce two-thirds to three-quarters of all the net new jobs, and community banks are a primary source of the capital that enables those small businesses to grow.* Moreover, providing subchapter S corporation relief builds upon recent legislation to reduce the impact of the double taxation of dividends, while focusing on small businesses, and offers a genuine opportunity for these small businesses to grow and create jobs.

There is strong support for reforming and simplifying subchapter S corporation rules. I have been joined on my legislation by seven other Members of the Ways and Means Committee, as well as an additional twenty-four other cosponsors. Moreover, subchapter S relief enjoys broad support from Members of this Committee based on support for bills introduced this year or last by Representatives Shaw and Ramstad.

I look forward to working with the Subcommittee, the full Committee on Ways and Means, and other interested parties to move these subchapter S corporation reforms forward. Again, I would like to thank the Select Revenue Measures Subcommittee for holding this hearing, and thank you for the opportunity to raise these important small business issues with you.

Statement of the Section of Taxation of the American Bar Association

EXECUTIVE SUMMARY

The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the ABA. Accordingly, these views should not be construed as representing the position of the ABA.

Congress enacted Subchapter S of the Internal Revenue Code as a part of the Technical Amendments Act of 1958. Pub. L. No. 85–866, 72 Stat. 1606 (1958), reprinted in 1958–3 C.B. 254, 298–305. The stated purpose of Subchapter S was to permit small businesses to select the form of business organization desired by the owners without the necessity of taking into account major differences in tax consequences. S. Rep. No. 1983, 85th Cong., 2d Sess. 87, reprinted in 1958–3 C.B. 922, 1008.

In 1982, Congress substantially revised Subchapter S by enacting the Subchapter S Revision Act of 1982. Pub. L. No. 97–354, 96 Stat. 1669 (1982). The 1982 revisions were designed to expand the eligibility for Subchapter S status and simplify the operation of S corporations. In 1996, Congress enacted the Small Business Job Protection Act of 1996 (the "1996 Act"). Pub. L. No. 104–188, 110 Stat. 1755 (1996). The 1996 Act included a number of provisions expanding the utility and availability of S corporations, including the elimination of the prohibition of an S corporation being the member of an affiliated group, therefore permitting an S corporation to own subsidiaries. A wholly-owned subsidiary was permitted by the 1996 Act to make a qualified Subchapter S subsidiary election (a "QSub election") resulting in disregarding entity treatment for the wholly-owned subsidiary, with the result that an S corporation is able to combine the results of its operations and its wholly-owned subsidiary corporations in a single tax return. The 1996 Act increased the numerical limitation on S corporation shareholders from 35 to 75 and permitted complex trusts to hold S corporation stock as electing small business trusts or "ESBTs."

Several bills have been introduced in the 108th Congress to address many of the problems S corporations and their shareholders encounter as a result of onerous and unnecessary statutory restrictions. These bills include: H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," introduced by Rep. Scott McInnis (R–CO); H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," introduced by Rep. Jim Ramstad (R–MN); and H.R. 1896, the "Subchapter S Modernization Act of 2003," introduced by Rep. E. Clay Shaw, Jr., (R–FL). Several of these bills include common proposals for revisions to the limitations on S corporations. The Shaw bill, which is the subject of these comments, is the current version of legislation previously introduced as H.R. 2576 and S. 1201 in the 107th Congress by Rep. Shaw in the House and by Senator Hatch (for himself and on behalf of Senators Breaux, Lincoln, Allard, Thompson, and Gramm) in the Senate. The following comments have been developed during the pendency of the 2001 proposals and have been updated to refer to the current version of the bill.

H.R. 1896 includes a number of Subchapter S modernization provisions, including the following:

- The members of a family (within 6 generations of a common ancestor) are treated as one shareholder.
- Nonresident aliens are allowed to be S corporation shareholders.
- The numerical shareholder limitation is increased from 75 to 150.
- The issuance of preferred stock by an S corporation would be permitted.
- Convertible debt would be eligible for the straight debt safe harbor.
- Excess passive income would no longer be a termination event.
- The sting tax would be imposed when passive investment income of an S corporation having accumulated earnings and profits exceeds 60 percent of gross receipts (rather than 25%); capital gains from the sale of stock or securities would no longer be included in gross receipts for this purpose.
- Shareholders would be allowed a full deduction for charitable contributions of appreciated property by an S corporation, by increasing shareholder basis to the extent the deduction exceeded the basis of the property contributed.
- Losses recognized by S corporation shareholders upon liquidation of an S corporation will be treated as an ordinary loss to the extent of basis increases attributable to ordinary income.
- The carryover of suspended passive activity losses from C to S years would be permitted.
- Suspended losses would be transferred to the transferee upon the transfer of S corporation stock incident to divorce.
- The disposition of S corporation stock by a QSST would trigger the recognition of suspended losses at the beneficiary level.
- The statutory restrictions on electing small business trusts ("ESBTs") would be relaxed to provide that:
  - Interest expense on debt incurred to acquire S corporation stock would be deductible by the S portion of an ESBT.
  - Unexercised powers of appointment would be disregarded in determining the potential current beneficiaries of an ESBT.
  - Distributions from an ESBT sourced to the S portion would be treated separately from a distribution sourced to the non-S portion.
  - Amounts contributed to charity by an ESBT pursuant to the terms of the governing instrument would be allowable as a deduction to the ESBT and taken into account as UBTI by the charity.

- S corporation shareholders would be permitted to increase basis for amounts loaned to the S corporation, even through the funds were obtained by the shareholder from a "back to back" loan from a related party.
- A bank S corporation would not include in the definition of "passive investment income" interest income from any source and dividend income from investments required to conduct a banking business.
- Shares of a bank S corporation held by a director ("qualifying director-shares") would not be treated as outstanding shares for purposes of the single class of stock requirement and allocations of income or loss.
- A bank S corporation would be permitted to recognize the section 481(a) adjustment resulting from the change from the reserve method of accounting for bad debts to the charge-off method in one year rather than over four years.
- The IRS would be granted authority to grant relief for inadvertent invalid or inadvertently terminated QSub elections.
- Q-Subs would be treated as separate entities for purpose of certain informational returns required under sections 6031 through 6060.
- The sale of an interest in a QSub, resulting in the termination of the QSub election, would be treated as the sale of an undivided interest in the subsidiary's assets followed by a deemed contribution by the S corporation transferor and the transferee to a new corporation in a section 351 transaction.
- A QSub election would be treated as a tax-free liquidation under section 332, without regard to the application of the step transaction doctrine (for example, in the case of a restructuring of an S corporation and its subsidiaries).
- Earnings and profits attributed to pre-1983 S years would be eliminated, without regard to whether the S election was in Gain or loss from deferred intercompany transactions would not be triggered on the conversion of a consolidated group to S corporation or QSub status, but would be treated as recognized built-in gain or loss when the asset is disposed of in a taxable transaction.
- Charitable contribution carryforwards and foreign tax credit carryfowards arising from a C year would be allowed as a deduction against net recognized built-in gain under section 1374.
- Distributions by an S corporation to an ESOP would be treated as a dividend for tax purposes under section 404(k)(2)(A), permitting the use of the distribution to make principal payments on an ESOP loan without violating the prohibited transaction rules and permitting the pass through of dividends to ESOP beneficiaries without the premature distribution penalties otherwise applicable to early distributions from qualified retirement plans.

COMMENTS ON ACT PROVISIONS

The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the ABA. Accordingly, these views should not be construed as representing the position of the ABA.

The Section of Taxation believes that the Subchapter S Modernization Act of 2003 (the "Act") represents a significant improvement to current law and we support its enactment. The Act would enhance the utility of the S corporation election to small businesses, promote fairness by mitigating certain traps under current law, and foster simplification by reducing transactional complexity now facing S corporations. We do, however, have comments regarding certain provisions and have suggestions regarding how the drafting of particular provisions of the Act could be improved from a technical perspective. The following discussion sets forth our comments on the provisions currently included in the Act.

Section 101—Members of Family Treated as 1 Shareholder

General Explanation. The Act provides that, solely for purposes of counting the number of shareholders of an S corporation to determine if there are no more than 75 shareholders (increased to 150 under Section 104 of the Act) (the "shareholder limit"), all "members of the family" with respect to which an election is in effect are treated as one shareholder. The members of the family would be comprised of a person known as the "common ancestor," the lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor. The lineal descendants included in the family under this provision are those up to six generations removed from the common ancestor, as of the later of the effective date of the provision (taxable years beginning after December 31, 2003) or the time an S corporation election is made. The election requires the consent of shareholders (including family members) holding in the aggregate more than one-half of the shares of stock in the corporation on the day the election is made. The provision also clarifies that the trustee of an electing small business trust and the beneficiary of a qualified subchapter S trust are to make the election. In conjunction with providing for the election to treat family members as one shareholder, the Act provides for relief when the election is inadvertently invalid or inadvertently terminated.

Comments. This provision would allow businesses owned by large families to obtain or retain S corporation status, without precluding employees or others from having an equity stake. This provision would be particularly helpful to a business owned in large part by a multigenerational family. Some multi-generational family-owned businesses currently are denied the benefit of S corporation status solely because there are too many family members to satisfy the numerical shareholder limitation. Increasing the number of shareholders an S corporation can have alone will not necessarily address the concerns of businesses owned by multigenerational families, since these families can consist of more than 150 members in some cases.

Recommendation. We support the enactment of this provision.

Section 102—Nonresident Aliens Allowed to Be Shareholders.

General Explanation. The Act would amend section 1361(b) to permit nonresident aliens to be S corporation shareholders. In concert with this amendment, section 1446 would be amended to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to its nonresident alien shareholders.

Comments. This provision would enhance the ability of an S corporation—which, by definition, must be a domestic corporation—to expand into international markets by providing it with the ability to offer an equity interest to an individual recruited to enhance its overseas business. In addition, the provision would increase the S corporation's access to foreign capital markets and would obviate the need to raise such capital through a partnership of which the S corporation is a partner. Eliminating the need to utilize a partnership structure would be a significant step towards simplification. Moreover, the bill would prevent significant revenue loss by subjecting nonresident alien shareholders to U.S. withholding tax on S corporation income. We also recognize the possibility that the current version of Subchapter S may be a violation of U.S. international tax treaties that preclude discrimination against nonresident aliens.

Under the Act, any withheld amount would be treated as distributed to the foreign shareholder by the S corporation on the earlier of—(i) the date the withholding tax is paid by the S corporation, or (ii) the last day of the S corporation's taxable year for which the tax is paid. This provision potentially raises an issue under the one-class-of-stock rules of Section 1361(b)(1)(D) by giving the foreign shareholder a different right to distributions than other shareholders. The Treasury regulations address a similar issue in the context of state law requirements for payment and withholding of income tax. In this connection, Treas. Reg. § 1.1361–1(1)(2)(ii) provides that state laws regarding withholding of state income taxes are disregarded in determining whether all shares of stock confer the same rights to distribution and liquidation proceeds, provided that, when the constructive distributions resulting from the payment or withholding are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. By analogy, as long as the remaining shareholders have the right to distributions that take the withholding tax distributions to the nonresident alien shareholders into account, the withholding provisions of section 1446 should not be deemed to create dissimilar rights to distributions for purposes of the one-class-of-stock rule.

Recommendation. We support the enactment of this provision as drafted. By analogy to the existing regulations under section 1361, it should be clear that the proposed statutory language does not create different rights to distribution and liquidation proceeds for purposes of the one-class-of-stock requirement. We recommend that this be confirmed by the appropriate committee reports or other legislative history accompanying the enactment of this provision.

Section 103—Expansion of Bank S Corporation Eligible Shareholders to Include IRAs.

General Explanation. The Act would amend section 1361(c)(2) to provide that a trust which is an individual retirement account (IRA) could be a permitted shareholder of an S corporation, but only in the case of a corporation that is a bank, and only to the extent of the stock held by the trust on the date of enactment of the provision. If an IRA is a shareholder in an S corporation, its allocable share of the income from the corporation will be subject to the tax imposed by section 511 on the unrelated business taxable income of certain exempt organizations. In addition, the Act would exempt from the prohibited transaction rules of section 4975 a sale of stock by an IRA in existence on the date of enactment to the individual for whose benefit the trust was established.

Comment. We generally support the expansion of the availability of the S corporation form by permitting IRAs to be shareholders of S corporations. We believe, however, that it would be helpful for any legislation allowing an IRA to be a shareholder to make clear to what extent the rules regarding unrelated business income tax ("UBIT") apply to the S corporation income that "flows through" to the IRA shareholder. Various other kinds of tax-exempt organizations and qualified retirement plans currently can hold S corporation stock; however, only employee stock ownership plans (ESOPS) are not subject to current tax on S corporation flow through income, and Congress has enacted "anti-abuse" legislation to address concerns with particular ESOP arrangements. Imposition of UBIT could raise administrative concerns in the context of IRAs.

We also could support a proposal similar to that proposed by Chairman Baucus in the markup document for the Small Business and Farm Recovery Act of 2002. Although the Senate Finance Committee postponed indefinitely the markup of that bill, the proposal would have allowed an IRA to transfer stock of a corporation to its beneficiary without triggering a "prohibited transaction" problem in order to allow the corporation to make an S corporation election. We would recommend that such a proposal apply to all corporations that are making S corporation elections, rather than being limited to a particular industry.

We take no position regarding whether Section 103 of the Act, which is targeted to banks and to IRAs that hold stock at a particular time, should be adopted.

Section 104—Increase in Number of Eligible Shareholders to 150.

General Explanation. The Act provides for an increase in the numerical limitation on the shareholders of an S corporation from 75 to 150.

Comments. This provision, consistent with other provisions in the Act, would make S corporation status accessible to more businesses operated in the corporate form without adding levels of administrative complexity.

Recommendation. We support the enactment of this provision. In the absence of a complete elimination of the shareholder limit, which would simplify the eligibility rules considerably, an increase in the number of shareholders that an S corporation may have, in conjunction with the new provision allowing members of a family to be treated as one shareholder for purposes of the shareholder limit, will be a welcome change facilitating the S election for more closely held businesses. Administrative issues relating to the increased number of shareholders of a corporate pass-through entity would be no more burdensome than the administrative issues that arise in connection with partnerships and limited liability companies taxable as partnerships, which are not subject to fixed numerical limitations on the number of partners or members.

Section 201—Issuance of Preferred Stock Permitted.

General Explanation. The Act would amend section 1361(f) to allow an S corporation to issue qualified preferred stock ("QPS"). QPS generally would be stock that (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). Stock would not fail to be treated as QPS merely because it is convertible into other stock. Further, QPS would not be treated as a second class of stock and a person holding QPS would not be treated as a shareholder of the S corporation. A distribution (not in payment for the QPS) would be "includible as ordinary income of the holder and deductible to the corporation as an expense in computing taxable income under section 1363(b) in the year such distribution is received."

Comments. One objective of this provision is to provide flexibility to S corporations in raising capital by allowing the S corporation to issue preferred stock. Generally, this senior equity must be "plain vanilla" preferred, except that a convertibility feature would not, in itself, cause the preferred stock not to qualify as QPS. Nevertheless, as a practical matter, preferred stock with a convertibility feature would seldom meet the definition of QPS. That is because most commonly used convertibility features, e.g., a fixed conversion rate such as one share common for one share preferred, would allow the preferred stock to participate in corporate growth to a significant extent. This would cause the stock to violate the requirement of section 1504(a)(4)(B) ("limited and preferred as to dividends and does not participate in corporate growth to any significant extent"). In fact, unless the conversion feature required the conversion to be based on a fair market valuation of the common stock at the date of conversion, it appears unlikely that convertible preferred stock could satisfy the requirements of Section 1504(a)(4)(B). Thus, while the ability to have preferred stock is certainly welcome, the utility of the provision as a source of capital is circumscribed. For example, because venture capital investors typically require that preferred stock contain a convertibility feature that allows the investor to participate in corporate growth to a significant extent, QPS probably would not be attractive to such investors.

The Act would facilitate family succession by permitting the older generation of shareholders to relinquish control of the S corporation while still maintaining an equity interest. It also would reduce transactional complexity by eliminating the need for the S corporation to enter into a joint venture with an investor who demands a preferential return (i.e., through use of a partnership structure). Therefore, we support this provision, subject to the comments herein.

The current language of the proposed amendment to section 1361(f) does not prescribe the specific treatment of the income to the holder and the deduction to the corporation. Instead, it merely describes the income as ordinary and the deduction as an expense.

Recommendation. If QPS is to fulfill an objective of opening another avenue of capital attraction to S corporations, it would be helpful for the convertibility feature to be broadened by amending the last sentence of section 1361(f)(2) to provide as follows:

> Stock shall not fail to be treated as qualified preferred stock merely because it is convertible into other stock and such convertibility feature allows a significant participation in corporate growth.

To provide certainty to S corporations and their shareholders, and to minimize the possibility of different interpretations by taxpayers and the Government, we recommend that the language of this provision be modified to provide that distributions with respect to QPS be treated as interest expense to the corporation, and interest income to the holder, respectively.

A potential issue also arises with respect to the timing of the income inclusion to the holder and the deduction of the S corporation. Under the current language, the income is includible as income of the holder, and deductible in computing taxable income under Code section 1363(b), in the year such distribution is received. However, as indicated in the example below, this language can be ambiguous.

> Example—A owns QPS in corporation X, an S corporation. A's taxable year ends November 30 and X's taxable year ends December 31. On December 31, 2001, X distributes to A $100,000 with respect to A's QPS. Is the distribution includible as income by A in its taxable year ending November 30, 2002 and deductible as expense by X in its taxable year ending December 31, 2002?

We recommend that section 1361(f) be rewritten as follows to eliminate the possible ambiguity with respect to this issue.

> "(3) Distributions.—A distribution (not in part or full payment in exchange for stock) made by the corporation with respect to qualified preferred stock shall be includible as income of the holder and shall be treated as deductible expense to the corporation for purposes of computing its taxable income under 1363(b). The income of the holder shall be includible, and any deduction of expense to the corporation under this chapter shall be allowable, as of the taxable year of the holder and the corporation, respectively, in which occurs the date that the distribution is received by the holder. Solely for purposes of section 265(a), qualified preferred stock shall be treated as indebtedness of the corporation issuing the qualified preferred stock.

Section 202—Safe Harbor Expanded to Include Convertible Debt.

General Explanation. Under current law, debt of an S corporation can qualify as safe-harbor debt only if (among other requirements) the creditor is an individual (other than a nonresident alien), an estate or a trust that is permitted to be an S corporation shareholder, or a person that is actively and regularly engaged in the business of lending money. Further, convertible debt cannot qualify as safe-harbor debt. Act section 202 would expand the safe-harbor debt provision to permit nonresident alien individuals, section 501(c)(3) organizations and certain trusts forming part of a qualified stock bonus, pension or profit-sharing plan as creditors. In addition, a convertibility feature would not automatically disqualify debt as safe-harbor debt provided the terms of the promise to repay, taken as a whole, are substantially the same as the terms which could have been obtained on the effective date of such promise from a person which is not a related person to the S corporation or its shareholders.

Comments. We believe that this provision would assist S corporations in obtaining capital and we support its enactment. Expanding the list of "permissible safe harbor" creditors to include nonresident alien individuals would be consistent with allowing such individuals to be S corporation shareholders directly. (See discussion above.) Similarly, allowing section 501(c)(3) organizations and certain trusts forming part of a qualified stock bonus, pension or profit-sharing plan to be "permissible safe-harbor" creditors is consistent with existing law which allows such persons to be shareholders of an S corporation. Finally, expanding the safe-harbor to include certain convertible debt would allow an S corporation an alternative source of financing without risking its S status due to the one-class-of-stock requirement.

Section 203—Repeal of Excess Passive Investment Income as a Termination Event.

General Explanation. Under current law, a corporation's status as an S corporation will terminate if (1) it has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable years more than 25 percent of which are "passive investment income." Section 1362(d)(3). In addition, an S corporation with accumulated earnings and profits is subject to a corporate-level "sting" tax during each year in which it has "excess" passive investment income under section 1375. This "sting" tax is intended to be a surrogate for the personal holding company tax that is imposed on C corporations with significant income from "passive" sources (such as certain rents, royalties and interest). Section 203 of the Act would repeal the rule that S corporation status terminates if a corporation with earnings and profits has excess passive investment income for three consecutive years, but would leave in place (subject to a modification in Act section 204, discussed below) the corporate level "sting" tax.

Comments. We support the enactment of this provision as drafted. The corporate-level "sting" tax alone is a sufficient deterrent to preclude a corporation from converting to S corporation status in order to avoid the personal holding company tax. Layering on the termination of S corporation status in situations where a corporation with earnings and profits has "excess" passive investment income for several years appears harsh. For example, consider the case where an S corporation discovers that it has had a single dollar of earnings and profits from a prior period as a C corporation that it has not yet distributed. It also has had gross receipts for 3 years of which 27 percent are from rent; clearly, losing its S corporation status is an exceptionally high price to pay for "foot-faulting" into a passive investment income situation. Although "inadvertent termination" relief may be available through petitioning the IRS, the availability of relief is not certain, and the taxpayer must bear the significant costs of preparing and filing a private letter ruling request.

Section 204—Modification of Section 1375 Sting Tax, Including Repeal of Passive Investment Income Capital Gain Category.

General Explanation. As indicated above, the "sting" tax of section 1375 is imposed upon S corporations that have both "excess" passive investment income and C corporation earnings and profits. For this purpose, passive investment income is defined in section 1362(d)(3)(C) as including "gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom)." Section 204 of the Act would remove gross receipts from sales or exchanges of stock or securities from the definition of passive investment income for purposes of the section 1375 tax. Because, as discussed above, the Act would repeal excess passive investment income as a termination event, Act section 204 also would insert the definition of passive investment income into the "sting" tax provisions of section 1375; currently, the definition is contained in the termination provision in section 1362(d)(3) and is merely cross-referenced in section 1375(b)(3). Act section 204 also would increase the required level at which the "sting" tax would occur so that a corporation would be subject to "sting" tax, only if more than 60 percent of its gross receipts constituted passive investment income, rather than more than 25 percent under current law.

Comments. We support this provision. As indicated above, the "sting" tax is intended to be a surrogate for the personal holding company tax imposed on C corporations under section 541. However, the definition of "personal holding company income" for purposes of section 541 does not include gross receipts from sales or exchanges of stock or securities; instead, it generally is limited to certain dividends, interest, royalties, and rents. See section 543. Further, there is no independent policy reason for including gross receipts from sales or exchanges of stock or securities in the definition of passive investment income for purposes of the 1375 corporate level tax. Thus, to achieve consistency with section 541, we recommend that this item be dropped from the definition of passive investment income. However, while gains from the sale or exchange of stock or securities are appropriately excluded as passive investment income, we recommend retention of a gross receipts modification by inserting paragraph (b)(4) as follows:

(4) Gross receipts from sales of capital assets. For purposes of paragraph (3), in the case of dispositions of capital assets, gross receipts from such dispositions shall be taken into account only to the extent of the capital gain net income therefrom.

In this respect, to the extent that Congress believes that a "sting" tax is appropriate, the suggested retention of a modification of the definition of gross receipts is necessary to avoid vitiating the "sting" tax provision.

Example—X is an S corporation with accumulated earnings and profits. X's only asset is a money market account of $10,000,000, which produces annual interest income in the amount of $500,000. On December 10, X purchases $500,000 of GE stock and on December 20, sells the GE stock for $500,000. Without the modification, no portion of the interest income would be subject to Code section 1375 sting tax, because X's passive investment income (interest of $500,000) would not be more than 60 percent of X's gross receipts ($1,000,000 gross receipts consisting of $500,000 interest income and $500,000 gross proceeds from the sale of GE stock).

Section 205—Allowance of Deduction for Charitable Contributions of Appreciated Property.

General Explanation. As indicated in the example below, the current Subchapter S rules discourage making charitable gifts of appreciated property through S corporations. Section 1366(d)(1) limits the amount of losses and deductions that flow through to a shareholder to the shareholder's basis in his or her stock and debt; however, there currently is no mechanism for increasing the shareholder's stock basis to reflect appreciation in property that is contributed to a charity. As a result, when an S corporation contributes appreciated property to a charity, the full amount of the deduction for the contribution may not be available to the shareholders at that time, notwithstanding Congressional intent to encourage charitable contributions through providing a fair market value deduction. The Act would remedy this problem by amending section 1367 to provide for an increase in the shareholders' basis to the extent of the excess of the deductions for charitable contributions over the basis of the property contributed.

Example—Bob contributes property with a basis of $500 and a value of $1,500 to his newly-formed S corporation in exchange for stock. At some later time, the property appreciates further in value to $2,000. The S corporation then contributes the property to a charity. (Assume no other assets, income or activity.) Under section 1366, the amount that flows through to Bob is limited to his $500 tax basis in his stock (with the remainder "suspended" indefinitely, until Bob has sufficient basis). Thus, Bob did not benefit from the fair market value deduction at the time because his stock basis did not reflect the property's appreciation. However, if Bob had never contributed the property to his corporation, he could have benefited from a $2,000 deduction.

Comments. We support the enactment of this provision as drafted. As indicated above, the current law rules undercut Congressional efforts to encourage charitable giving through providing a fair market value deduction. Further, charitable contributions through partnerships currently are treated more favorably than charitable contributions through S corporations because the statutory provisions for partnerships are different than those for S corporations; this has allowed the IRS the flexibility to reach the proper policy result in the partnership situation. (See Rev. Rul. 96–11, 1996–1 C.B. 140 for the treatment of charitable contributions by a partnership.) The Act would modify the S corporation statutory rules to produce the proper result for S corporations as well and to remove a potential trap for the unwary who make charitable contributions of appreciated property through S corporations.

Section 301(a)—Treatment of Losses to Shareholders/Liquidations.

General Explanation. The Act would amend section 331 to provide that the portion of any loss recognized by an S corporation shareholder on amounts received by the shareholder in a distribution in complete liquidation of the S corporation would be treated as an ordinary loss to the extent of the shareholder's "ordinary income basis" in the S corporation stock. The "ordinary income basis" of the shareholder would be an amount equal to the portion of such shareholder's basis in such stock equal to the aggregate increases in such basis under section 1367(a)(1) resulting from the shareholder's "pro-rata share of ordinary income of such S corporation attributable to the complete liquidation."

Comments. We believe that this provision is necessary in order to prevent character mismatches on the liquidation of S corporations and support the provision, with the following comment. We also believe, however, that the definition of "ordinary income basis" is drafted too narrowly since it can be interpreted to encompass only ordinary income recognized upon a distribution of property in complete liquidation of the corporation. Ordinary income basis should also include ordinary income recognized in connection with sales or exchanges of S corporation property that arise pursuant to certain dispositions that are made before, but in contemplation of, liquidation.

In certain circumstances, the language of proposed section 331(c) also may provide unintended benefits. For example, consider the situation below:

X, an S corporation, has 3 assets:

	Adj. Basis	*FMV*
Land	$2,000,000	$1,000,000
Inventory (1)	1,000,000	2,000,000
Inventory (2)	2,000,000	1,000,000
TOTAL	$5,000,000	$4,000,000

A, X's sole shareholder, has $6,000,000 basis in his S corporation stock.

On liquidation of X—

Land	($1,000,000) capital loss
Inventory (1)	1,000,000 ordinary income
Inventory (2)	(1,000,000) ordinary loss
TOTAL	($1,000,000)

A's stock basis: $6,000,000 − 1,000,000 + 1,000,000 − 1,000,000 = $5,000,000.

Loss on liquidation: $4,000,000 − $5,000,000 = (1,000,000)

Proposed section 331(c) arguably would treat this loss as ordinary loss (because of the $1,000,000 ordinary income), even though there is no need for recharacterization in this situation. In this respect, the gain on the sale of Inventory (1) and the loss on sale of Inventory (2) arguably are not netted under section 1366(a)(1)(B) and are separately stated under section 1366(a)(1)(A) because the separate treatment of those items could affect the liability for tax of any shareholder.

Recommendation. We recommend that the definition of ordinary income basis be modified to reflect a concept similar to that contained in section 453(h)(1), i.e., include ordinary income recognized upon a sale or exchange of property by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted, provided that all of the assets of the corporation are distributed in complete liquidation within such 12-month period. To prevent unintended benefits, we further recommend that the character of the stock loss be recharacterized only to the extent of *net* ordinary income resulting from such sale or exchange.

Section 301(b)—Suspended Passive Activity Losses.

General Explanation. The Act would amend section 1371(b) to permit the carryover of suspended passive activity losses from a year in which a corporation was a C corporation to a year in which the corporation is an S corporation.

Comments. This provision would codify the result in St. Charles Investment Co. v. Commissioner, 232 F. 3d 773 (10th Cir. 2001). In St. Charles, the Tenth Circuit reversed a Tax Court decision that had held that suspended passive activity losses may not be carried forward when a corporation converts from a C corporation to an S corporation. The Tenth Circuit resolved a tension between sections 1371(b)(1) and 469(b). Section 1371(b)(1) provides that "[n]o carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation." Section 469(b) provides that "[e]xcept as otherwise provided *in this section* (emphasis added), any loss . . . from an activity which is disallowed under subsection (a) shall be treated as a deduction . . . allocable to such activity in the next taxable year." The Tenth Circuit concluded that the plain language of section 469 precludes application of section 1371 to the suspended passive activity losses of a corporation in the first year of its S election. Suspended passive activity losses from C years were made available as a deduction against both passive activity gains and other ordinary income upon the disposition of the passive activity.

Recommendation. We support the enactment of this provision as drafted. This provision represents a helpful clarification of the relationship between sections 1371(b)(1) and 469. Suspended passive activity losses from C years would be treated as deductions against passive activity gains in subsequent S years, and (as in St. Charles) would become available as a deduction against both passive activity gains and other ordinary income upon the disposition of the passive activity in a subsequent S year.

Section 302—Transfer of Suspended Losses Incident to Divorce.

General Explanation. Under current section 1366(d), because losses disallowed due to a shareholder having insufficient basis in stock and debt of an S corporation ("suspended losses") are carried over to a subsequent year only "with respect to that shareholder," once a shareholder transfers all of his/her shares to another person the suspended losses vanish and are not available to be used by anyone. The Act would provide an exception for transfers incident to a decree of divorce.

Comment. Because of the frequency of stock transfers in divorce situations, an exception for divorce situations from the general rule in section 1366(d) that losses are not available to transferees would be very meaningful and helpful. Thus, we believe this provision is necessary and add the following comment. As drafted, by referring to "any loss or deduction . . . attributable to such stock" the provision appears to suggest that if a shareholder transfers only some of his/her stock incident to a decree of divorce, only a portion of the suspended losses of the shareholder will become available to the transferee and the remaining amount will remain with the transferor shareholder. This approach is equitable and clearly preferable to making all of the suspended losses of a transferor shareholder available to the transferee. However, the provision is not completely clear. Thus, it may be helpful to explain, perhaps in legislative history, that a proration concept is contemplated when suspended losses become available upon the transfer of a portion of stock to a transferee incident to a decree of divorce.

Recommendation. We support the enactment of this provision. We recommend clarification that if a shareholder transfers only some of his/her stock incident to a decree of divorce, only the pro rata amount of losses attributable to the transferred shares be included in the transfer of the stock.

Section 303—Use of Passive Activity Loss and At-Risk Amounts by Qualified Subchapter S Trust Income Beneficiaries.

General Explanation. The Act would amend section 1361(d)(1) to clarify that the disposition of S corporation stock by a trust electing QSST status shall be treated as a disposition of the stock by the QSST beneficiary for purposes of applying the passive activity loss and the at-risk limitations of sections 465 and 469(g).

Comments. The QSST beneficiary is taxed on all of the items of income, loss, deduction and credit attributable to the ownership of S stock by the QSST. However, gain or loss realized upon the sale of S corporation stock by a QSST is taxable to the QSST rather than the QSST beneficiary under Treas. Reg. § 1.1361–1(j)(8).

It appears that Act Section 303 is intended to trigger the recognition of loss by the S Corporation shareholder upon the disposition of S corporation stock, otherwise suspended under the passive loss and at-risk limitation of sections 465 and 469(g). Since the current regulations treat the disposition of S corporation stock by a QSST as the termination of the QSST election and provide for the recognition of gain or loss on the sale as gain or loss to the trust, the Act clarifies that such disposition also triggers the recognition of suspended losses at the beneficiary level.

Recommendation. While we support the enactment of this provision, we recommend that the committee reports accompanying the bill clarify that the disposition of S corporation stock by a QSST should be treated as a disposition of such stock by the taxpayer otherwise required to recognize income attributable to such disposition under applicable law and regulations (i.e. the QSST) and that the amendment is intended to clarify that suspended losses attributed to such stock are recognized by the beneficiaries upon such disposition.

Sections 304, 305, 306 and 307—Clarification of Electing Small Business Trust Provisions.

Background. The 1996 Act permitted multiple beneficiary trusts to own S corporation stock provided the trust meets the requirements of an "electing small business trust" or "ESBT" set forth in code section 1361(e)(1), including the following:

a. the beneficiaries must be individuals, estates or certain nonprofit organizations;
b. no interest in the trust may have been acquired by purchase;
c. the trust makes a proper election to be treated as an ESBT;
d. the trust does not also make a QSST election with respect to the stock of the same S corporation; and
e. the trust is not exempt from tax.

All of the potential current beneficiaries of an ESBT, as defined in Code section 1361(e)(2), are counted for the purposes of the 75-shareholder limitation (150 under the Act) and must be permitted S corporation shareholders in their own right.

An ESBT is taxed on the income attributable to the ownership of the stock in the S corporation at the highest marginal rate, without the benefit of the personal exemption, in accordance with code section 641(d). For purposes of Subchapter J, the portion of the ESBT that owns stock in an S corporation is treated as a separate trust under section 641(d)(1)(A). The taxation of this separate trust is determined under ESBT rules, while the non-ESBT portion of the trust is taxed under the normal Subchapter J rules. Section 641(d)(1), (2), and (3). The S corporation's income items are not included in the calculation of the distributable net income (DNI) of the trust. No deduction is allowed for the distribution of Subchapter S pass-through income to the ESBT beneficiaries.

The Internal Revenue Service issued final regulations on May 14, 2002, providing detailed guidance on the qualification and taxation of ESBTs. The final regulations provide that an ESBT will be treated as having an "S portion" and a "non-S portion." A grantor trust may make an ESBT election, provided that the "grantor portion" is taxed to the grantor under the grantor trust rules. Distribution to beneficiaries are first considered to be distributed from the non-S portion of the trust, carrying out DNI to the beneficiary receiving the distribution, without regard to the source of the distribution.

General Explanation. Section 304 of the Act amends section 641(c)(2)(C) to provide that any interest expense incurred to acquire stock in an S corporation is deductible by the S portion in determining taxable income of an ESBT. Section 305 of the Act amends section 1361(e)(2) to clarify that unexercised powers of appointment are disregarded in determining the potential current beneficiaries of an ESBT and providing for a one-year correction period during which an ESBT could dispose of stock after an ineligible shareholder becomes a potential current beneficiary. Section 306 of the Act amends section 641(c)(1) by adding a new subparagraph (b) providing that any distribution attributable to the portion of an ESBT treated as a separate trust (the "S portion") shall be treated separately from any distribution attributable to the non-S portion. Finally, Section 307 of the Act amends section 641(c)(2)(C) to provide that an ESBT may deduct amounts contributed to charity as described in section 642(c)(1), provided that amounts received by the charity from an ESBT shall be taken into account as unrelated business taxable income of the charity, to the extent that such amount is deducted by the ESBT.

Comments. Sections 304, 305, 306 and 307 of the Act modify certain provisions of the regulations finalized by the Internal Revenue Service on May 14, 2002 (see T.D. 8994 (May 14, 2002)).

Section 304. The final regulations provide that interest expenses paid by a trust electing ESBT status on indebtedness incurred in connection with S corporation stock must be allocated to the S portion of the ESBT, and such interest expenses are *not* deductible by the S portion because they are not administrative expenses as limited by the current statutory language. Treas. Reg. § 1.641(c)-1(d)(4)(ii). The final regulations provide that interest expenses incurred to purchase S corporation stock do not increase the basis of the stock held by the S portion. Section 304 of the Act amends Section 641(c)(2)(C) to correct this anomaly and provide that interest expense incurred to acquire stock in an S corporation is deductible by the S portion of the ESBT.

Section 305. The final regulations further provide that a person entitled to receive a distribution from an ESBT only after a specified time or upon the occurrence of a specified event is not a potential current beneficiary until such time or the occurrence of the event. For example, the holder of a testamentary power of appointment and the permitted appointees under the power of appointment would not be considered potential current beneficiaries until the death of the power holder, when the testamentary directions will take effect. On the other hand, the final regulations provide that the existence of a currently exercisable power of appointment, such as a general lifetime power of appointment that would permit distributions to be made from the trust to an unlimited number of appointees, would cause the S corporation election to terminate since the number of potential current beneficiaries will exceed the numerical shareholder limit (75 under current law and 150 under the Act). Section 305 of the Act amends Section 1361(e)(2) to clarify that unexercised powers of appointment are disregarded in determining the potential current beneficiaries of an ESBT. In addition, Section 305 increases the period during which an ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from 60 days under current law to 1 year. Accordingly, an ESBT will have one year from the occurrence of an event that entitles an ineligible shareholder to receive a distribution from the trust to dispose of the S corporation stock without resulting in the termination of the S election.

Section 306. The final regulations continue the approach originally announced by the Service in Notice 97–49, 1997–1 C.B. 385 and the proposed regulations issued on December 29, 2000 with respect to the treatment of distributions from an ESBT to beneficiaries. Under the regulations, distributions to beneficiaries from the S portion or from the non-S portion are first considered to be distributed from the non-S portion of the trust, taxable under Subchapter J to the extent of the distributable net income of the trust (the DNI). As a result, distributions that may be clearly sourced from the S portion, even made on the same day received from the S corporation, are treated as distributions from the non-S portion. Section 306 of the Act changes the results set forth in the final regulations by providing that any distribution attributable to the S portion shall be treated separately from any distribution attributable to the non-S portion.

Section 307. The final regulations provide that a charitable contribution is deductible in determining the taxable income of the S portion only if it is attributable to a charitable contribution by the S corporation. The regulations provide that such a contribution will be deemed to be paid by the S portion of the ESBT pursuant to the terms for the trust's governing instrument within the meaning of Section 642(c)(1) so that the charitable deduction is allowable in determining the taxable income of the S portion. Treas. Reg. § 1.641(c)-1(d)(2)(ii). Section 307 of the Act expands the charitable deductions allowable in determining the taxable income of an ESBT to include amounts contributed directly by the ESBT to the charity pursuant to the terms of the governing instrument. The Act provides that such amounts received by a charity directly from an ESBT shall be taken into account as unrelated business taxable income of the charity, to the extent such amount is deducted by the ESBT.

Recommendation. We support the proposed amendments clarifying the electing small business trust provisions as set forth in Sections 304, 305, 306 and 307 of the Act. With respect to Section 306 of the Act, providing for separate treatment or "tracing" of distributions attributable to the S portion from distributions attributable to the non-S portion, we suggest that the appropriate Committee reports or legislative history accompanying the Act clarify that the trustee of an ESBT may allocate distributions to the S portion or non-S portion using any reasonable method. Insofar as Sections 305 and 306 of the Act modify certain provisions of the final regulations issued by the Internal Revenue Service on May 14, 2002, we recommend that the effective dates of these provisions be changed to the earliest date that the final regulations would have otherwise become effective. (As drafted, Section 305 is effective for taxable years beginning after December 31, 2003 and Section 306 is effective for taxable years beginning after December 31, 1996). We recommend that Section 304 and 307, at the election of the taxpayer, be applied to taxable years beginning after December 31, 1996.

However, we further agree with the simplification recommendation of the Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," April 26, 2001, that an ESBT be subject to taxation under the normal rules of Subchapter J. We do not believe that the ownership of S corporation stock by a complex trust presents difficult tax policy or tax administration problems. Other pass-through entities, including partnerships, limited liability companies classified as partnerships for income tax purposes, and REITs, may be held by complex trusts with multiple beneficiaries under existing law. In light of the compression of the individual tax rates, the limitations on the use of multiple trusts, and the "kiddie tax" provisions (subjecting the income of children under age 14 to tax at the highest marginal rate of the parents), there is little opportunity for tax avoidance or tax minimization by trusts through allocations of income among beneficiaries. Given the income tax limitations on trusts under Subchapter J and the compression of income tax rates, any concerns that income would be distributed only to persons who have large losses to offset the income, that income would be distributed to unrelated persons, or that distributions would be made from year to year in order to minimize income taxes, are not well-founded.

Section 308—Shareholder Basis Not Increased By Income Derived From Cancellation of S Corporation Debt.

General Explanation. Act section 308 would reverse the result in Gitlitz v. Commissioner, 531 U.S. 206 (2000) by amending section 1366(a)(1) to exclude cancellation of indebtedness income excludable under Section 108 as an item of income that flows through to an S corporation shareholder. This would prevent any increase in the shareholder's basis in S corporation stock.

Comment. Pub. Law 105–206, Sec. 6004(f)(1) has effectively addressed the basis increase allowed under Gitlitz by amending section 108(d)(7)(A) to provide that any COD income excluded at the corporate level under Section 108(a) is not taken into account under section 1366(a). That provision generally is effective for discharges of indebtedness after October 11, 2001, in tax years ending after October 11, 2001.

Section 309—Back-to-Back Loans as Indebtedness.

General Explanation. Section 1366(d)(1)(B) currently allows an S corporation shareholder to deduct losses allocable to the shareholder under section 1366(a) to the extent of the shareholder's adjusted basis in the shareholder's stock and the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder. The Act amends Code section 1366(d) to clarify that a back-to-back loan (a loan made to an S corporation shareholder who in turn loans those funds to his S corporation) constitutes "indebtedness of the S corporation to the shareholder" within the meaning of section 1366(b)(1)(D) so as to increase such shareholder's basis in the S corporation. This provision would allow an S corporation shareholder to increase his basis in the S corporation by the amount he loans to the S corporation, even though the amounts loaned by the shareholder to his S corporation are obtained by the shareholder by means of a loan from another person even if the person loaning the funds to the shareholder is related to the shareholder.

Background. Under section 1366(d), the aggregate amount of an S corporation's losses and deductions taken into account by a shareholder for any taxable year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation plus the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Any loss or deduction that is disallowed for any taxable year by this provision will be treated as incurred by the corporation in the succeeding taxable year with respect to that taxpayer.

The IRS has held (and the courts have agreed) that to increase the basis in the indebtedness of an S corporation, there must be an economic outlay on the part of the shareholder. The required economic outlay must leave the taxpayer "poorer in a material sense." Perry v. Commissioner, 54 T.C. 1293, 1296 (1970).

The economic outlay requirement has caused a great deal of confusion for S corporation shareholders in situations in which the funds loaned to the S corporation are borrowed from a related lender. We believe that most practitioners, in advising clients about structuring alternatives for financing S corporation activities, take the position that back-to-back loan transactions among the lender (including lenders related to the shareholder and/or the S corporation), the shareholder, and the S corporation result, or should result, in the shareholder obtaining basis in indebtedness of the S corporation to the shareholder.

Recommendation. We support the enactment of this provision. The amendment of section 1366(d)(1)(B) clarifying this result will help many shareholders avoid inequitable pitfalls encountered where a loan to an S corporation is not properly structured, even though the shareholder has clearly made an economic outlay with respect to his investment in the S corporation for which a basis increase is appropriate, and alleviate the significant amount of litigation arising out of back to back loan transaction where the shareholder obtains funds lent to an S corporation from a related person. We recommend that the legislation state that the revisions to section 1366(d)(1)(B) should not be interpreted to infer the status of the law prior to the amendments.

Section 401—Exclusion of Investment Securities Income from Passive Income Test for Bank S Corporations.

General Explanation. The Act would provide for additional exclusions from the definition of "passive investment income" for purposes of section 1375(b)(3) (as amended by Act section 204(b)(1)) (relating to the tax on excess net passive investment income). In the case of a bank, bank holding company, or qualified subchapter S subsidiary that is a bank, the defined term would exclude both interest income from any source and dividend income from certain investments required to conduct a banking business.

Comments. Notice 97–5, 1997–1 C.B. 352, was issued shortly after the enactment of the 1996 Act, which first allowed banks to be S corporations and qualified subchapter S subsidiaries. In this Notice, the Service excluded interest income on investments necessary to meet "reasonable liquidity needs (including funds needed to meet anticipated loan demands)", but did not provide the unqualified exclusion that the proposed legislation would provide.

Recommendation. We support the enactment of this provision.

Section 402—Treatment of Qualifying Director Shares.

General Explanation. The Act would amend section 1361 to provide that "qualifying director shares" would not be treated as a second class of stock, and that no person shall be treated as a shareholder of the corporation by reason of holding qualifying director shares. Such shares would be defined as shares of stock in a bank or bank holding company which are held by an individual solely by reason of status as a director and which are subject to an agreement pursuant to which the holder is required to dispose of the shares of stock upon termination of the holder's status as a director at the same price as the individual acquired such shares of stock. In a manner similar to the treatment of restricted stock under section 83, any dividend distributions with respect to qualifying director shares will be treated as ordinary income to the holder and deductible to the corporation. Because these shares would not be treated as outstanding, no allocations would be made with respect to such stock under section 1366(a).

Comments. It is not clear whether current law is inadequate to deal with the circumstance of an individual who is required to hold nominal title to shares of stock in a bank or bank holding company in order to serve as a director of that organization. Present law would apparently apply traditional benefits-and-burdens test to determine whether a director is the Federal tax owner of stock subject to the type of agreement described in the proposed legislation. In a case where the issuing bank or bank holding company, rather than the individual director, is the Federal tax owner of the stock, presumably the stock would not be treated as outstanding, and thus could not violate the single-class-of-stock requirement applicable to S corporations.

Recommendations. We recommend that the committee reports accompanying the bill specify whether the proposal is intended to be a safe-harbor provision or the exclusive means of avoiding a second-class-of-stock issue in this context.

Proposed section 1361(g)(1) would provide that the operative rules described above apply "[f]or purposes of this subchapter", *i.e.*, subchapter S. We recommend that further consideration of the scope of the operative rules should be undertaken. For example, it might be appropriate to cause these rules to be applicable for purposes of chapter 1 of the Code rather than solely subchapter S, so that qualifying director shares are not treated as stock for purposes of subchapter C.

Proposed section 1361(g)(2)(i) (which should be designated as section 1361(g)(2)(A)) would define "qualifying director shares" as shares of stock held by an individual "solely by reason of status as a director" of the bank, bank holding company, or its controlled subsidiary. We recommend that the definition be clarified so that it achieves its apparent purpose, *e.g.*, shares "which are required to be held by an individual under applicable Federal or state law in order to permit such individual to serve as a director of such bank or company or its controlled subsidiary".

We also recommend that, in appropriate committee reports or other legislative history, it would be clarified that "qualifying director shares" will not be treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary. This conclusion may already be apparent from Treas. Reg. § 1.1361–2(b), but further clarification would be appropriate and helpful.

Section 403—Recapture of Bad Debt Reserves.

General Explanation. The Act would establish an "off Code" provision that would permit an S corporation bank to recognize the section 481(a) adjustment resulting from the required change from the reserve method of accounting for bad debts to the charge-off method in one year (either the taxable year ending with or beginning with the election), rather than ratably over four years under current method-change procedures.

Comments. A financial institution that uses the reserve method of accounting for bad debts is not permitted to be an S corporation. However, if a financial institution desires to make an S corporation election, or to have a qualified subchapter S subsidiary election made for it by its parent S corporation, it may change from the reserve method to the specific charge-off method, effective not later than the beginning of the taxable year for which the S corporation or qualified subchapter S subsidiary election becomes effective. Rev. Proc. 97–18, 1997–1 C.B. 642, first set forth the procedures for a reserve-method bank to make an automatic method change to the specific charge-off method in connection with an S corporation or qualified subchapter S subsidiary election. These automatic procedures are currently set forth in Rev. Proc. 99–49, 1999–2 C.B. 725. In general, if the automatic method change is made, the positive section 481(a) adjustment, which is generally equal to the amount of the bank's reserve for tax purposes as of the beginning of the year of change, is required to be included in income ratably over a four-year period. This section 481(a) adjustment is treated as a built-in gain, for purposes of section 1374, in each of the years in which the adjustment is included in income. As the bank begins to apply the specific charge-off method, however, its deductions for bad debts with respect to loans held by the bank on the date of conversion from C corporation to S corporation status are treated as built-in losses for section 1374 purposes only to the extent that the deductions are taken within the first taxable year of the S corporation status. Treas. Reg. § 1.1374–4(f). Section 1374 does not permit S corporations to carry forward unused recognized built-in losses to subsequent years in the recognition period in order to offset recognized built-in gains. Accordingly, an S corporation bank may incur a tax liability under Code section 1374(a) solely because of the combined effects of the four-year section 481(a) adjustment period and the one-year rule for the specific charge-off of bad debts.

Recommendations. We recommend several changes to improve the scope and clarity of the proposal:

1. Statutory provisions affecting the Code that are not actually enacted into the Code present traps for the unwary taxpayer and practitioner. We recommend that this provision should be enacted as part of section 481.
2. We recommend that the provision clarify that the treatment is elective, by providing that "such bank may *elect to* recognize" the section 481(a) adjustment over one year.
3. As currently drafted, the provision refers to the bank's recognition of "built-in gains" from the method change. Because it purports to modify the rules and procedures generally applicable to section 481, we recommend that it provide that the election applies to shorten the period for recognizing "the adjustment required by section 481(a)".
4. We recommend that the provision apply, in addition to an S corporation election made by a bank, to a qualified subchapter S subsidiary election made for a subsidiary of a bank holding company.
5. It is not clear what is intended by referring to the taxpayer's choice to include the section 481(a) adjustment "either in the taxable year ending with or beginning with such an election." It is plausible that the drafters intended the electing corporation to take the section 481(a) adjustment into account in full in either its last taxable year as a C corporation or its first taxable

year as an S corporation. Because an S corporation election becomes effective on the first day of the taxable year of the corporation, there is no taxable year that "end[s] with . . . such an election." Therefore, we recommend that the language relating to the year of recognition of the section 481(a) adjustment be restated as "either the taxable year immediately preceding the taxable year for which the election is first effective or the taxable year for which the election is first effective."

Section 501—Relief for Qualified Subchapter S Subsidiary Elections That Are Inadvertently Invalid of Inadvertently Terminated.

General Explanation. The Act would amend section 1362(f) to provide statutory authority for the Secretary to grant relief for invalid QSub elections and terminations of QSub status if the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent. This would allow the IRS to provide relief in appropriate cases, just as it currently can in the case of invalid or terminated S corporation elections.

Comments. We support the enactment of this provision. Section 1362(f) currently provides the IRS with authority to grant relief for S corporation elections that are inadvertently invalid or inadvertently terminated. Taxpayers typically seek such relief through the private letter ruling process. Numerous petitions for relief are granted each year, reflecting the fact that it is common for taxpayers to inadvertently run afoul of the S corporation eligibility requirements.

It is inevitable that taxpayers similarly will inadvertently fail to meet the eligibility requirements for Qualified Subchapter S Subsidiary ("QSub") status. For example, an inadvertently invalid election could occur where an S corporation makes a QSub election for a subsidiary that it in good faith believes it wholly owns, but later discovers that an arrangement with a third party that was structured as debt constitutes equity in the subsidiary for Federal tax purposes. However, there currently is no mechanism for taxpayers to receive relief from the IRS. The IRS had provided for inadvertent QSub termination relief in the proposed QSub regulations, but removed this provision from the final regulations because of concerns that it lacked the authority to provide relief without an explicit statutory mandate from Congress. (See the preamble to the final QSub regulations under section 1361.)

Section 502—Information Returns for QSubs.

General Explanation. The Act would provide that, in the case of information returns required under part III of subchapter A of chapter 61 (*i.e.*, sections 6031 through 6060), a QSub would be treated as a separate entity and would not be treated as, in effect, a division of the parent S corporation.

Comments. Section 1361(b)(3)(A) currently provides the Secretary with authority to provide exceptions to the general rule that, for Federal tax purposes, a QSub is not treated as a separate corporation but instead is treated as a division of the parent S corporation. The Treasury and IRS have provided certain exceptions to this general rule for banks and for employment tax purposes, and have authority to provide additional exceptions. It is not clear why this change is necessary or appropriate. We recommend that a QSub be treated as a disregarded entity for purposes of information returns required under Part III of subchapter A of section 61 (sections 6031 through 6060) which would be required of the S corporation parent.

Recommendation. We do not perceive any justification for the enactment of this provision. We recommend that the informational returns otherwise required under current law be required to be filed by the S corporation parent, since the existence of the QSub is disregarded for federal tax purposes, except to the extent provided by regulations.

Section 503—Sale of an Interest in a QSub.

General Explanation. Act Section 503 would clarify the tax treatment of the termination of a corporation's status as a QSub where the termination is a result of disposition of stock in the QSub. Under section 1361(b)(3)(E), a termination by reason of disposition of stock in the QSub would be treated as a sale of an undivided interest in the subsidiary's assets based on the percentage of the stock transferred followed by a deemed contribution by the S corporation transferor and the transferee to a new corporation in a section 351 transaction.

Comments. Section 1361(b)(3)(C) provides that if any QSub ceases to meet the QSub eligibility requirements, it will be treated as "a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock." The legislative history to the 1996 Act is silent as to how this deemed contribution of assets, subject to liabilities, should be treated for Federal tax purposes.

The final regulations on QSubs apply the step transaction doctrine to the deemed transfer of assets to the "Newco" in exchange for Newco stock. As indicated below, the examples in the final regulations illustrate how the application of this doctrine can lead to recognition of 100 percent of the gain in a QSub's assets where as little as 21 percent of the subsidiary's stock is sold. The examples also illustrate how this inappropriate result can be avoided through a merger or through structuring the sales transaction differently.

Example 1 of Treas. Reg. § 1.1361–5(b)(3) sets forth a situation where an S corporation sells 21 percent of the stock of a QSub to an unrelated purchaser for cash, thereby terminating the QSub election. The example notes that the S corporation may have to recognize gain on the assets deemed transferred to the subsidiary because the deemed transfer would not qualify for nonrecognition treatment under section 351 (i.e., because the S corporation is not "in control" of the subsidiary immediately after the transfer, as a result of the sale of the stock). As a result, the transfer is treated as fully taxable.

Example 2 of Treas. Reg. § 1.1361–5(b)(3) is the same as above, except that immediately prior to the sale of the interest in the subsidiary, the subsidiary is merged into a single member limited liability company (LLC) owned by the S corporation. In this case, the sale of the 21-percent interest in the entity results in the formation of a partnership for Federal tax purposes. Under Rev. Rul. 99–5, 1999–1 C.B. 434 that sale is treated as the sale of 21 percent of the entity's assets, followed by a contribution of all of the entity's assets to a partnership. Under this scenario, the S corporation recognizes gain on only 21 percent of the subsidiary's assets.

Example 3 of Treas. Reg. § 1.1361–5(b)(3) is the same as Example 1, except that the unrelated party contributes an asset to the subsidiary in exchange for 21 percent of the subsidiary's stock, instead of purchasing 21 percent of the subsidiary's stock from the S corporation. In this situation, the transaction would qualify for treatment under section 351 because the S corporation and the unrelated party would be viewed as co-transferors that are in control of the subsidiary immediately after the transaction.

We believe that Congress did not intend when it enacted legislation that was intended to facilitate S corporation-QSub structures for an S corporation to recognize 100 percent of the gain on the deemed sale of a QSub's assets when it sells less than 100 percent of the QSub's stock. Moreover, although the regulations provide examples of how this result can be avoided through structuring alternatives, it is inefficient to make taxpayers engage in otherwise meaningless activity solely to be taxed on the proper amount of gain or to penalize taxpayers who are unaware of the need to employ such structuring alternatives.

Recommendation. We support the enactment of this provision, with the following technical suggestions. First, we recommend that the provision be modified to apply to "transfers" of QSub stock and use consistent language throughout; as currently drafted, the provision characterizes all dispositions as sales. This will create confusion in the case of dispositions as sales. In this same connection, we recommend that the statutory provision and the accompanying legislative history make clear how the provision applies in the case of transfers of QSub stock in the context of nonrecognition transactions. For example, when a QSub is merged with and into another corporation (the "acquiring corporation"), we recommend that the provision specify that the acquiring corporation is treated as having acquired the QSub's assets, and having assumed its liabilities, from the S corporation, in exchange for the acquiror's stock. As another example, we recommend that the legislative history make clear that, if an S corporation transfers, say, 30 percent of the stock of a QSub to a partnership in exchange for a partnership interest in what otherwise qualifies as a section 721 exchange, the tax consequences of the transfer should be determined as if the S corporation had transferred an undivided interest in 30 percent of the QSub's assets to the partnership in a section 721 exchange and then the S corporation and the partnership had contributed their respective interests in the assets to a new corporation in exchange for stock.

Second, we recommend that the provision be modified to make clear that the tax consequences of the sale of *all* of the stock of a QSub shall be determined as if the S corporation first transferred all of the subsidiary's assets to the transferee in an asset sale, followed by a contribution of such assets by the *transferee* to a new corporation. In such case, there is no joint contribution by the S corporation and the transferee, but a contribution by the transferee to a new corporation controlled by the transferee.

Third, we do not believe it is necessary to state that the deemed contribution that follows the deemed transfer of an undivided interest in the assets is a section 351 transaction; instead, the tax consequences of the deemed contribution should be based on general principles of tax law. We recommend that the legislative history make clear, however, that the deemed contribution will qualify as a section 351 transaction if the requirements of Code section 351 otherwise are satisfied. Further, we recommend that the statute or the legislative history make clear that the deemed contribution is made to a new corporation in exchange for stock of such corporation.

Finally, we recommend that the provision apply retroactively only by election, given that taxpayers who understood current law already have engaged in transactions based on the final QSub regulations.

Section 504—Provide Exception to Application of "Step Transaction Doctrine" for Restructuring in Connection with Making QSub Elections.

General Explanation. The Act amends section 1361(b)(3) to provide that a QSub election shall be treated as a deemed liquidation to which Code section 332 applies, without regard to the application of the step transaction doctrine.

Comments. The legislative history to the Small Business Job Protection Act of 1996, P.L. 104–188 (the "1996 Act" or the "SBJPA"), provided that "if an election is made to treat an existing corporation (whether or not its stock was acquired from another person or was previously held by the S corporation) as a QSub, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective." H.R. Rept. 104–586 at p. 89 and Joint Committee General Explanation of Tax Legislation Enacted in 104th Cong., JCS–12–96 ("Blue Book") at p. 121. The legislative history to the technical corrections legislation enacted in 1997 clarified that Treasury has the authority to provide, in appropriate cases, exceptions to the general rule that a QSub election is treated as a deemed liquidation under section 332. It did not, however, provide any examples as to what kinds of exceptions would be appropriate. (H.R. Rept. 105–48 at p. 644.)

Final regulations regarding QSubs apply the "step transaction doctrine" to determine the tax consequences of the deemed liquidation resulting from the QSub election (subject to a limited transition rule that already has expired). Under the regulations, the deemed liquidation is collapsed together with the restructuring that was necessary to make the QSub election in order to determine the Federal tax consequences of the transactions. As explained below, the application of the step transaction doctrine requires a knowledge of the intricacies and vagaries of Subchapter C, and can lead to surprising and uncertain results in certain cases.

We believe that, as a general rule, it is not appropriate to apply the step transaction doctrine to the restructuring associated with making a QSub election. As illustrated by the examples below, applying the doctrine can lead to dramatically different Federal tax consequences in some cases than if the deemed liquidation resulting from the QSub election were treated as a separate liquidation (e.g., treatment as a stock acquisition, plus a separate liquidation).

> Example 1: Assume that A, the sole shareholder of two solvent S corporations, determines that she would like to operate the two corporations in a parent/subsidiary structure. Indeed, the legislative history of the QSub legislation indicated that the QSub rules were intended to allow shareholders to arrange their "separate corporate entities under parent/subsidiary arrangements as well as brother-sister arrangements." House Report at p. 89 and S. Rep. No. 281, 104th Cong., 2d. Sess. 54–55 (1996) ("Senate Report"). Therefore, A contributes all of her stock in one S corporation (Corpl) to the other S corporation (Corp2). Corp2 elects to treat Corp1 as a QSub. At the time of the transaction, the liabilities of Corp1 exceed Corp1's basis in its assets. If the step transaction is not applied, the transaction will be treated as a tax-free exchange by A of the stock of Corp1 for stock of Corp2 under section 351 (or a tax-free reorganization under section 368(a)(1)(B)), followed by a tax-free liquidation of Corp1 under Code sections 332 and 337 pursuant to the QSub election. However, if the step transaction doctrine is applied, the transaction will be treated as a "D" reorganization (i.e., a reorganization under section 368(a)(1)(D)). See Rev. Rul. 67–274, 1967–2 C.B. 141 and Rev. Rul. 78–130, 1978–1 C.B. 114. Under this analysis, the QSub election would trigger gain to Corp1 pursuant to Code section 357(c) to the extent its liabilities exceeded its basis in its assets.

Example 2: Assume that ABC Corporation, an S corporation, acquires all of the stock of Target Corporation from its shareholder, T, an unrelated individual, in exchange for $50 cash and $500 worth of ABC voting stock, representing 10 percent of ABC's outstanding stock. Target has no liabilities. After the acquisition, ABC makes a QSub election for Target. If the step transaction does not apply to this acquisition, the transaction would be treated as a taxable acquisition of the stock of Target, followed by a tax-free liquidation under sections 332 and 337. See Rev. Rul. 90–95, 1990–2 C.B. 67. The acquisition of the stock of the Target cannot qualify as tax-free because it does not meet the requirements to be a tax-free reorganization under Code section 368(a)(1)(B) (there is boot in the transaction) or the requirements to be a tax-free Code section 351 transaction because T does not control ABC immediately after the transaction). However, if the step transaction doctrine is applied, the acquisition would qualify as a tax-free reorganization under section 368(a)(1)(C) because all of Target's assets are acquired in exchange for voting stock of the acquiring corporation and no more than 20 percent additional consideration (i.e., cash). Note that, in this example, the Government benefits if the doctrine is not applied.

As indicated by the above examples, applying the step transaction doctrine introduces complexity and uncertainty into what should be a simple matter of making the QSub election. The step transaction doctrine is derived from numerous cases and rulings dealing with various fact situations; as a result, it is subjective in nature and does not always yield certain results. Further, applying the doctrine requires knowledge of decades of jurisprudence and administrative interpretations. However, many S corporations are small businesses that do not have the benefit of sophisticated counsel who are experts in the intricacies of Subchapter C. Similarly, because some S corporations may view the act of making a QSub election as simple, they may not seek out sophisticated tax advice. These taxpayers will end up being surprised when audited to learn that the IRS views what they thought was a simple matter—acquiring 100% ownership of a company and making a QSub election—as having unanticipated tax consequences.

We also believe that a general rule that applies the step transaction doctrine to the deemed liquidation from a QSub election is inconsistent with Congressional intent in enacting the QSub provision, as reflected in the legislative history of the 1996 Act. The QSub provision was intended (among other things) to facilitate restructuring into parent/subsidiary structures. However, as indicated above, application of the doctrine can frustrate such restructuring by producing surprising results for the unwary and requiring sometimes costly analysis of the Subchapter C rules.

Moreover, as also illustrated in the examples above, applying the step transaction doctrine does not always result in a pro-Government result; conversely, not applying the doctrine does not always produce a pro-taxpayer result. The argument for not applying the doctrine is based on making the consequences of a QSub election simple and certain for all taxpayers, especially those smaller businesses that do not have the benefit of sophisticated tax advice.

Nonetheless, we recognize that there are certain limited situations in which applying the step transaction doctrine makes more sense as a matter of tax policy, produces more straightforward results, and minimizes the creation of traps for the unwary. For example, assume an S corporation forms a new subsidiary for which it makes an immediate QSub election. Because the subsidiary is deemed to have liquidated a moment after it was formed, it makes sense to treat the formation and deemed liquidation as non-events for Federal tax purposes, rather than to determine tax consequences based on a formation and a separate and independent liquidation. As another example, assume an existing S corporation is restructured so that it becomes a QSub of a newly-formed S corporation holding company, the only asset of which is the QSub stock. In such case, nothing of Federal tax significance has occurred and it makes sense to treat the transaction as an "F" reorganization of the S corporation (i.e., both at the beginning and end of the day, there is just a single S corporation for Federal tax purposes).

Recommendation. We support the enactment of this provision, with the following technical suggestion. In recognition of the fact that there are limited situations in which applying the step transaction doctrine is proper, we recommend that the Treasury be given regulatory authority to provide appropriate exceptions to the general rule that a QSub election is treated as a liquidation under section 332. We recommend that the legislative history make clear that such regulatory authority should be exercised only in limited situations, such as those described immediately above, where an S corporation makes a QSub election for a newly-formed subsidiary or where an S corporation becomes a QSub of a new holding company.

Section 601—Elimination of All Earnings and Profits Attributable to Pre-1983 S Election Years.

General Explanation. Under the current scheme of S corporation taxation, accumulated earnings and profits of an S corporation may be relevant for purposes of several provisions, including, treatment of distributions under section 1368(c) and application of the section 1375 sting tax.

Act Section 601 clarifies a provision in the 1996 Act, Section 1311(a), which eliminated from an S corporation's accumulated earnings and profits the portion of earnings and profits which was accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Nevertheless, the elimination of accumulated earnings and profits under the 1996 Act Section 1311(a) only applies if the corporation is an S corporation for its first taxable year beginning after December 31, 1996. Act Section 601 amends the 1996 Act Section 1311(a) with respect to any taxable year beginning after December 31, 1996 (the general effective date of the 1996 Act S corporation provisions) to eliminate the requirement that an S corporation must have had an S election in effect for its first taxable year beginning after December 31, 1996.

Comments. We support the enactment of this provision. The 1996 Act Section 1311(a), was intended to eliminate a trap for the unwary and complicated recordkeeping requirements for a corporation that might have accumulated earnings and profits from a pre-1983 taxable year for which an S election was in effect. Congress did not articulate, nor are we aware of, a reason why the benefits of the provision should be confined to a corporation that had an S election in effect for its first taxable year beginning after December 31, 1996.

Section 602—Provide That Gain/Loss from Deferred Intercompany Transactions Is Not Triggered on Conversion to S Corporation or QSub Status, But Is Treated As Recognized Built-In Gain/Loss When the Deferred Gain/Loss Is Taken into Account.

General Explanation. Act Section 602 is an off-Code provision that directs that section 1502 (consolidated return regulations) not cause gain or loss to be recognized in connection with an S election or a QSub election.

Comments. As a result of changes made by the 1996 Act, the common parent of a consolidated group can elect to be an S corporation and to treat its consolidated subsidiaries as QSubs (assuming the S corporation and QSub eligibility requirements are satisfied). However, when these elections are made, there is uncertainty as to whether gain or income from "old intercompany transactions" between members of the consolidated group is required to be taken into income in the group's last consolidated return. As explained below, the consolidated return regulations, read together with the final QSub regulations, indicate that such income is <u>not</u> taken into account in the final consolidated return. However, it appears that some in the IRS may believe that such income must be taken into account in the consolidated return, out of concern that the income cannot be subject to the section 1374 "built-in gain" tax in the future and, therefore, may escape corporate tax entirely. Thus, as explained below, we recommend that section 1374 be amended to treat such income or gain as recognized built-in gain when it is taken into account by the S corporation (i.e., it would be subject to corporate-level tax at that time), with the legislative history clarifying that such income is not taxed at the time of the S corporation and QSub elections. We further recommend that consideration be given to providing similar treatment for "new intercompany transactions."

Discussion. Because an S corporation is an "ineligible corporation" within the meaning of section 1504(b) and cannot be included in a consolidated group, a consolidated group's existence terminates if the common parent elects to be treated as an S corporation (whether or not it also elects to treat its subsidiaries as QSubs). If the parent elects to be treated as an S corporation and also elects to treat a wholly-owned solvent subsidiary as a QSub, both the legislative history of the 1996 Act and the final QSub regulations indicate that the QSub election will be treated as a deemed liquidation of the subsidiary under section 332. In cases where the parent S corporation makes simultaneous S election and QSub elections for all of its subsidiaries, the regulations treat the deemed liquidations as occurring at the close of the day before the QSub elections are effective. Therefore, if the parent of a consolidated group makes an election to be an S corporation and a QSub election for its subsidiary, both of which are effective on the same day, the deemed liquidation occurs prior to the termination of the consolidated group.

The consolidated return regulations provide two different sets of rules governing the treatment of intercompany transactions that take place within a consolidated group: the Old Intercompany Regulations, that are applicable to "old" deferred intercompany transactions occurring in tax years beginning before July 12, 1995; and the New Intercompany Regulations, that are applicable to intercompany transactions occurring in tax years beginning on or after that date.

Both sets of regulations provide that if the consolidated group ceases to file consolidated returns, gains and income from intercompany transactions must be taken into account in the final consolidated return.[1] However, the two sets of regulations have different exceptions to the recognition of deferred gains and income when the buying and selling members are liquidated into the common parent of the consolidated group under section 332, prior to the deconsolidation of the group.

Under section 1.1502–13(f)(2)(ii)(b) of the Old Intercompany Regulations, the provision that causes deferred gain and/or income from intercompany transactions to be taken into account when the group ceases to file consolidated returns is made inapplicable if:

> The group is terminated, and immediately after such termination the corporation which was the common parent . . . owns the property involved and is the selling member or is treated as the selling member . . . Thus, for example, subparagraph (1)(iii) [regarding the restoration of gain/income upon the termination of the group] does not apply in a case where corporation P, the common parent of a group consisting of P and corporations S and T, sells an asset to S in a deferred intercompany transaction, and subsequently all of the assets of S are distributed to P in complete liquidation of S. Moreover, if, after the liquidation of S, P sold T, subparagraph (1)(iii) of this paragraph would not apply even though P ceased to be a member of the group.

Further, under the Old Intercompany Regulations, the common parent is treated as the selling member with respect to a deferred intercompany transaction if the selling member is liquidated into the common parent in a tax-free liquidation under section 332.[2] Therefore, gain/income from deferred intercompany transactions that occurred in tax years beginning before July 12, 1995, would not be taken into income under the applicable regulations provided that the buying and selling corporations were liquidated tax-free into the common parent under section 332 prior to the group ceasing to file consolidated returns. In this case, the former common parent would continue to defer the recognition of gain/income from such transactions. Because the QSub regulations indicate that the liquidation resulting from the QSub election occurs in the final consolidated return, it appears that the gain/income from "old" deferred intercompany transactions should continue to be deferred. Such gain/income should be taken into account by the former common parent (i.e., the S corporation) when an event occurs that, under the Old Intercompany Regulations, requires it to take such amounts into income (e.g., the property is sold).

Some Government officials, however, have suggested unofficially that the Old Intercompany Regulations should be interpreted to provide that, in these situations, the former common parent is required to take the gain/income from deferred intercompany transactions into income when the former common parent becomes an S corporation. Although there does not appear to be anything in the Old Intercompany Regulations to support this interpretation, this interpretation apparently is being advanced out of concern that, unless gain/income from deferred intercompany transactions is taken into account in the final consolidated return, such gain/income will escape corporate tax entirely. This concern appears to be based on the fact that section 1374 and the regulations promulgated thereunder may not subject deferred gain/income to the section 1374 built-in gain tax, even if such gain or income is taken into account within 10 years of conversion to S

[1] Former Reg. § 1.1502–13(f)(1)(iii); Reg. §§ 1.1502–13(d)(1) and (d)(3) Example 1(f). Likewise, both sets of regulations provide that losses and deductions from such transactions will remain deferred under Code section 267. Former Reg. §§ 1.267(f)-2T(d)(1), 1.267(f)-IT(c)(5); and Reg. § 1.267(f)-l(c)(1)(i).

[2] Former Reg. § 1.1502–13(c)(6).

corporation status.[3] Although this concern may be well founded given the current form of the section 1374 regulations, the better solution is to make clear that the section 1374 tax applies in this situation. Otherwise, the current confusion almost certainly will lead to years of controversy and litigation.

For later intercompany transactions, the New Intercompany Regulations seem to provide that gain/income from such transactions must be included in income when the common parent becomes an S corporation. Although these regulations contain a similar exception to the recognition of deferred gain/income when the consolidated group terminates as a result of the tax-free liquidation of the members into the common parent, such exception applies "so long as [the common parent] neither becomes a member of an affiliated group filing separate returns nor becomes a corporation described in Section 1504(b)."[4] As described above, the 1996 Act added S corporations to the list of non-includable corporations described in section 1504(b). As a result, the exception in the New Intercompany Regulations to the recognition of deferred gain/income on the termination of a consolidated group may be inapplicable to situations where the group is terminated as a result of the common parent electing to be an S corporation and filing QSub elections for the other members of its group. It is unclear whether this result was intended because these regulations were written prior to the amendment to add S corporations to section 1504(b). While a legislative change may not be necessary to avoid litigation and confusion with regard to gain/income from "new" intercompany transactions, we believe that consideration should be given to subjecting gain/income from "new" intercompany transactions to the same regime as old intercompany transactions—i.e., no gain triggered upon conversion to S corporation status or election of QSub status, but subject to the built-in gains tax when taken into account. This result would protect against the avoidance of corporate tax without introducing unnecessary tax burdens on taxpayers seeking to convert to S corporation status.

Recommendation. We recommend that section 1374 be amended to provide that, in the case of simultaneous S corporation and QSub elections, gain or income from an intercompany transaction occurring in tax years beginning before July 12, 1995 shall be treated as a recognized built-in gain for the taxable year in which the S corporation disposes of such property. For the sake of simplicity, we recommend that consideration also be given to applying this provision to all deferred intercompany transactions, without regard to whether they occur on, before or after the July 12, 1995 date. In addition, we recommend that the legislative history make clear that such gain or income is not included in the final consolidated return of the group.

Section 603—Treatment of Subchapter C Attributes for Purposes of the Built-In Gains Tax—Charitable Contribution and Foreign Tax Credit Carryforwards.

General Explanation. The Act amends section 1374(b)(2) to provide that charitable contribution carryforwards and foreign tax credit carryforwards arising from a taxable year for which the corporation was a C corporation shall be allowed as a deduction against the net recognized built-in gain of the corporation for the taxable year. The Act directs the Secretary to promulgate regulations providing for similar treatment of other carryforwards attributable to taxable years for which an S corporation was a C corporation.

Comments. Section 1374 provides for the imposition of a corporate-level "built-in gain" tax on the recognition of gain by an S corporation that formerly was a C corporation (or acquires an asset whose basis is determined by reference to the basis of such asset in the hands of a C corporation), but only to the extent such gain reflects unrealized appreciation in the assets on the last day of the corporation's final C year (or as of the date of acquisition from the C corporation). This tax was intended to prevent C corporations from circumventing the Tax Reform Act of 1986's repeal of the General Utilities doctrine by electing to be treated as

[3] The section 1374 regulations provide that the built-in gain tax will apply only to two kinds of gain/income: gain from the sale or exchange of built-in gain property and income that would have been properly taken into account prior to conversion to S corporation status by an accrual basis taxpayer ("built-in income" items). See Treas. Reg. § 1.1374–4(a) and (b). Gain/income from a deferred intercompany transaction arguably does not fall within either category. Consider a situation where there is a deferred gain from the sale of property between members of the group and such property does not appreciate after the sale. The property is not built-in gain property because its tax basis (i.e., the buying member's purchase price) does not differ from its value. Likewise, the deferred gain is not income that an accrual basis taxpayer would have properly included prior to the conversion to S corporation status.

[4] Reg. § 1.1502–13(j)(6).

S corporations and then disposing of their assets. (The 1986 Act, among other things, generally required C corporations to recognize gain on liquidating distributions of assets.)

Section 1374(b)(2) generally provides that a net operating loss or capital loss carryforward arising in a taxable year for which the corporation was a C corporation can be used to reduce "net recognized built-in gain" (the tax base for the built-in gains tax). Treas. Reg. § 1.1374–5 provides that the only loss carryforwards allowed as a deduction in computing the tax are those specified in section 1374(b)(2) and that "any other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2) are not allowed as deductions" in computing the tax.

Denying the corporation the ability to use these carryforwards and losses can result in the benefit of these attributes being lost forever and is not justified by any policy reason. Given that the built-in gains tax is a surrogate for tax that would have been imposed had the corporation remained a C corporation, an S corporation should be able to reduce the tax by items that would have offset corporate tax if the corporation had remained a C corporation. In fact, in describing the enactment of the built-in gains tax, the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, JCS–10–87 (May 4, 1987) provides that:

> [t]he corporation may take into account **all** of its subchapter C tax attributes in computing the amount of the tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses, capital loss carryovers, **and similar items** to offset the gain or the resulting tax. [Emphasis added.]

The language used in current sections 1374(b)(2) and 1374(b)(3), and the amended section 1374(b)(5) as proposed by the Act, refers to carryforward attributes "arising in a taxable year for which the corporation was a C corporation." This language can be read as limiting the benefits of such carryforwards solely to carryforwards generated by an S corporation that has converted from C corporation status. Nevertheless, such carryforwards also might be available to an S corporation under section 381 as a result of a carryover in a corporate acquisition. In this respect, assets acquired from a C corporation in such a transaction would be subject to built-in gains tax under section 1374(d)(8).

Recommendation. We support the proposed amendment to section 1374 to allow Subchapter C attributes such as charitable contribution carryforwards and foreign tax credit carryforwards to be taken into account in computing the "built-in gains" tax. We recommend that the language in sections 1374(b)(2) and 1374(b)(3) and section 1374(b)(5) as proposed by the Act be clarified so that carryforward attributes of a C corporation that carryover to an S corporation also are carryforward attributes that are taken into account in computing built-in gain and the amount of built-in gains tax.

The following language would accomplish this clarification:

> Section 1374(b)(2) is amended by inserting "(or the corporation generating the net operating loss carryforward)" after the words "in a taxable year for which the corporation" in the first sentence of section 1374(b)(2).

> Section 1374(b)(2) is amended by inserting "(or the corporation generating the capital loss carryforward or charitable contribution carryforward)" after the words "in a taxable year for which the corporation" in the second sentence of section 1374(b)(2) (as currently proposed to be amended by Act Section 603(a)).

> Section 1374(b)(3)(B) is amended by inserting "(or the corporation generating the business credit carryforward)" after the words "arising in a taxable year for which the corporation" in the first sentence of section 1374(b)(3)(B).

> Section 1374(b)(3)(B) is amended by inserting "(or the corporation generating the minimum tax credit or foreign tax credit carryforward)" after the words "attributable to taxable years for which the corporation" in the second sentence of section 1374(b)(3)(B) (as currently proposed to be amended by Act Section 603(b)).

> Section 1374(b)(5) is amended by inserting "(or the corporation generating the attribute)" after the words "for which an S corporation" and before the words "was a C corporation."

Section 604—Distribution by an S Corporation to an Employee Stock Ownership Plan.

General Explanation. The Act would enact a new section 1368(f) to provide that a distribution by an S corporation to an employee stock ownership plan (ESOP) is treated as a dividend under section 404(k)(2)(A). The Act would also amend section 404(a)(9)(C) to provide that the deduction provided in section 404(a)(9) does not apply to an S corporation.

Comments. ERISA section 406(a)(1)(B) and section 4975(c)(1)(B) of the Code forbid any "direct or indirect . . . lending of money or other extension of credit between a plan and a party in interest." Absent an exception, this prohibition would disallow any debt financing for the acquisition of employer stock by an Employee Stock Ownership Plan ("ESOP"), where a party in interest extends credit through a direct loan or loan guarantee. ERISA section 408(b)(3) and section 4975(d)(3) offer an exemption, however, from the prohibited transaction rules provided the ESOP and the employer meet certain requirements. If these provisions are met, the ESOP may borrow money using a direct loan or a loan guarantee from a party in interest to accomplish its purchase of employer stock.

One of the requirements for the exemption mandates that the ESOP's liability for repayment of the loan be limited to the following: (i) collateral given for the loan, (ii) contributions made to the ESOP for loan repayment purposes (other than contributions of employer stock), and (iii) earnings attributable to such collateral and the investment of such contributions. Treas. Reg. § 54.4975–7(b)(5)(i), (ii), and (iii), DOL Regs. § 2550.408b–3(c). Additionally, payments made with respect to an exempt loan by the ESOP must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years. Treas. Reg. § 54.4975–7(b)(5). This language does not appear to allow distributions made by an S corporation on ESOP-owned stock which has been allocated to participant accounts to be used to make payments on an applicable ESOP loan. Consequently, in the S corporation setting, no method exists for repaying the principal of the ESOP loan from distributions made on stock owned by an ESOP which has been allocated to participant accounts pursuant to section 4975(d). In the C corporation area, however, an ESOP may apply dividends received from its sponsor in payment of the loan made on stock acquired with its proceeds regardless of whether such stock has been allocated to participants. Section 404(k)(2)(A)(iii).

Another requirement under Treas. Reg. § 54.4975–11(f)(3) states that income paid with respect to qualifying employer securities acquired by an ESOP may be distributed any time after receipt by the ESOP to participants on whose behalf such securities have been allocated. This language, however, does not provide a vehicle for ESOPs to distribute to participants earnings received by it from its S corporation sponsor penalty free unless the distribution fails under one of the exceptions outlined in section 72(t)(2)(A). Instead, these pass-through payments constitute "premature distributions". Along with premature distribution status comes the imposition of a ten percent (10%) excise tax under section 72(t) on early distributions from qualified retirement plans, distribution restrictions under section 411(a)(11), and special withholding requirements under section 3405. In contrast, dividends paid with respect to stock of a corporation which are described in section 404(k) are exempt from these burdensome provisions.

Moreover, all of the regulatory interpretations of these statutory provisions were promulgated long before S corporations were permitted to have ESOP shareholders and thus do not reflect regulatory considerations of S corporation issues arising in connection with ESOPs.

Distributions on stock acquired by an S corporation sponsored ESOP through an ESOP loan should be eligible to be applied in payment of the loan regardless of whether the stock giving rise to the distribution has been allocated to participant accounts in the same way that the dividends of a C corporation can be applied to payment of such loans.

Dividends received by an ESOP sponsored by a C corporation can be passed through to its participants at the option of the ESOP under section 404(k)(2)(A)(i) without being denominated as "premature distributions" subject to the adverse ramifications attendant thereto. The pass through to participants of earnings received from an S corporation that sponsors an ESOP, however, does result in "premature distributions." As an owner of stock, the ESOP should have the option to pass through S corporation earnings received by it as distributions pro rata to its participants in the same manner as can C corporations. The provisions of the tax law governing S corporation ESOPs should not contain impediments discouraging such distributions.

Proposed new subsection (f) of section 1368 extends to ESOPs sponsored by S corporations the same options presently available to C corporation ESOPs with respect to earnings received, whether in the form of dividends or distributions which are conceptually equivalent (even though S corporation distributions will still not produce tax deductions). Specifically, all such distributions will be able to be applied in payment of a stock acquisition loan, and will also qualify for pass through treatment to ESOP participants at the option of the ESOP without penalties and onerous requirements that would otherwise apply.

Recommendation. We support the enactment of these provisions of the Act as drafted. These provisions will remove certain impediments to the use of ESOPs sponsored by S corporations. The enactment of section 1368(f) would eliminate any uncertainty as to whether distributions made by an S corporation to an ESOP with respect to allocated shares could be used to make principal payments on the ESOP loan without violating the prohibited transaction rules. The modification of section 404(a)(9)(C) would clarify that provisions of section 404(a)(9) other than the deduction-allowance provision would continue to apply to S corporations. The continued application of such other provisions to S corporations is important, for example, because provisions elsewhere in the Code incorporate some of the rules of section 404(a)(9) by reference. The current version of section 404(a)(9)(C), which made all of section 404(a)(9) inapplicable to an S corporation, created uncertainty as to whether an S corporation could rely on any provision of the that referred to section 404(a)(9).

Thompson & Knight, LLP
Dallas, Texas 75201
July 2, 2003

The Honorable Jim McCrery
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
2104 Rayburn House Office Building
Washington, D.C. 20515–1804

Re: S Corporation Reforms

Dear Representative McCrery:

This letter is being submitted in response to the Advisory from the Committee on Ways and Means Subcommittee on Select Revenue Measures dated June 19, 2003, regarding S corporation reforms.

As the Advisory recognized, several bills have been introduced this Congress that address many of the problems S corporations and their shareholders face, including H.R. 714, the "Small Business and Financial Institutions Tax Relief Act of 2003," introduced by Rep. Scott McInnis (R–CO); H.R. 1498, the "Small Business Opportunity and Growth Act of 2003," introduced by Rep. Jim Ramstad (R–MN); and H.R. 1896, the "Subchapter S Modernization Act of 2003," introduced by Rep. E. Clay Shaw, Jr., (R–FL). The purpose of the hearing on S corporation reforms held on June 19, 2003, was to give the Subcommittee a better understanding of Subchapter S of the Internal Revenue Code of 1986, as amended (the "Code"), and possible reforms to it.

The purpose of this letter is encourage the Subcommittee to continue its efforts to simplify Subchapter S of the Code, to remove the rules and restrictions on S corporations that unnecessarily inhibit their growth, and to make corporate earnings subject to only one level of tax. While this letter is being submitted on behalf of an interested client that is an S corporation ("Client"), we believe that the concerns of Client are shared by many S corporations.

Potential Current Beneficiary of Electing Small Business Trust (ESBT). Client is wholly-owned by an electing small business trust (an "ESBT"), of which an individual is the sole current beneficiary ("Beneficiary"). Upon Beneficiary's death, the Trust will be divided into multiple separate trusts for Beneficiary's heirs. Unless disclaimed, each of Beneficiary's heirs will have lifetime and testamentary powers of appointment over their respective trusts.

An S corporation may have only certain types of shareholders and cannot have more than 75 qualifying shareholders. If an S corporation has an ineligible shareholder or more than 75 qualifying shareholders, its S election will terminate automatically. When an ESBT holds S corporation stock, each "potential current beneficiary" of the ESBT is considered a shareholder of the S corporation for purposes of eligibility and the 75 shareholder limitation.

Section 1361(e)(2) of the Code defines a "potential current beneficiary" as, "with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust." In enacting the ESBT rules, Congress intended for a trust that provides for income to be distributed to, or accumulated for, a class of individuals to be allowed to hold S corporation stock. Such a trust is commonly known as a "spray" trust because it allows the trust to "spray" income among family members or others who are beneficiaries of the trust.

The term "potential current beneficiary" is used to determine who is treated as a shareholder of the S corporation. The term should not include an unlimited class of persons to whom a current beneficiary might conceivably, sometime in the future, transfer his interest and his right to distributions. The term should include only the specific class of persons to whom a person currently has discretion to distribute principal or income. Thus, the term "potential current beneficiary" should not include the persons in whose favor a power of appointment may be exercised until the power of appointment is actually exercised in such persons' favor.

This concern is addressed by section 305 of H.R. 1896, which would amend section 1361(e)(2) of the Code to say the following (changes in italics):

> For purposes of this section, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust *(determined without regard to any unexercised (in whole or in part) power of appointment during such period).* If a trust disposes of all of the stock which it holds in a S corporation, then, with respect to such corporation, the term "potential current beneficiary" does not include any person who first met the requirements of the preceding sentence during the 1-year period ending on the date of such disposition.

Consistent with the Subcommittee's goals, this provision would remove a restriction that unnecessarily inhibits the use of S corporations, particularly by families.

Passive Investment Income. Client converted from a C corporation to an S corporation several years ago. Because Client has earnings and profits from when it was a C corporation, Client must monitor its passive investment income.

If Client has passive investment income in any one year that makes up more than 25% of its gross receipts, Client may be subject to a corporate-level tax. If Client's passive investment income exceeds 25% of its gross receipts for three consecutive years, Client's S election will terminate.

"Passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stock or securities. "Gross receipts" means the total amount received or accrued under the method of accounting used by Client in computing its taxable income without reduction for returns and allowances, cost of goods sold, or deductions. Thus, to avoid the corporate-level tax and the revocation of its S election, Client's income from royalties, rents, dividends, interest, annuities, and the sale of stock and securities must equal 25% or less of Client's total gross receipts.

Section 203 of H.R. 1896 would no longer cause excessive passive investment income to terminate a company's S election. Section 204 of H.R. 1896 would cause the corporate-level tax on excess net passive income to apply only if the gross receipts from passive investment income exceeds 60% (rather than 25%) of total gross receipts. In addition, section 204 would limit the items included in the definition of "passive investment income" to "royalties, rents, dividends, interest, and annuities." Thus, gains from the sale or exchange of stock or securities would no longer be treated as an item of passive income.

The corporate-level passive investment income tax, sometimes called the "sting" tax, is imposed so that C corporations cannot convert to S corporations and thereby avoid the personal holding company tax that applies to C corporations. The corporate-level tax is a sufficient deterrent against a C corporation converting to S corporation status to avoid the personal holding company tax. In addition, the removal of capital gains from the definition of passive investment income makes the tax base for the sting tax consistent with the tax base for the personal holding company tax (see I.R.C. § 543).

These provisions are consistent with the Subcommittee's goals because they eliminate a trap for the unwary that can cause the loss of a company's S election and make corporate earnings more likely to be subject to only one level of tax.

Built-In Gains Tax. Because Client converted from a C corporation to an S corporation, it must monitor the gain from the sale of its assets for 10 years. As Client sells assets during the 10-year period after its S election, it must pay a corporate-level tax at the highest corporate rate on the built-in gain in those assets on the date of its S election.

Section 2 of H.R. 1498 would not impose this corporate-level tax if proceeds from the sale of built-in gain assets are used for certain qualified expenditures, including investment in property used in the S corporation's trade or business.

This provision is consistent with the Subcommittee's goals because it relaxes a rule that unnecessarily inhibits the growth of S corporations while at the same time providing an incentive for an S corporation to reinvest in other business assets. In addition, this provision makes corporate earnings more likely to be subject to only one level of tax.

* * *

In summary, we applaud the Subcommittee's efforts to simplify Subchapter S of the Code, to remove the rules and restrictions on S corporations that unnecessarily inhibit their growth, and to make corporate earnings subject to only one level of tax. By disregarding unexercised powers of appointment when determining the potential current beneficiaries of an S corporation, a restriction will be removed that unnecessarily inhibits the use of S corporations, particularly by families. If excessive passive investment income no longer a terminates a company's S election, a trap for the unwary is removed. The proposed changes to the passive investment income tax and the built-in gains tax make corporate earnings more likely to be subject to only one level of tax. They also decrease the likelihood of S corporations becoming subject to these corporate-level taxes and thus simplify tax compliance for many S corporations.

Please contact me if you have any questions or desire any additional information.

Yours very truly,

Mary A. McNulty

Statement of Washington Council Ernst & Young

Washington Council Ernst & Young (WCEY) appreciates the opportunity to submit testimony on behalf of its clients to the Subcommittee as part of its hearing on Subchapter S reform. We applaud the committee for giving serious consideration to the need to modernize Subchapter S of the Internal Revenue Code and we recommend that you specifically consider policies that will enable more employee-owned businesses to operate under the Subchapter S rules.

Many older, established companies that began as sole proprietorships and ultimately incorporated under Subchapter C did so at a time when the tax code did not allow the current flexibility of entity choice. As a result, some of these C corporations, especially those that are entirely owned by a broad base of employees and directors, find themselves at a competitive disadvantage relative to newer companies that have been able to avail themselves of the more tax efficient rules that govern limited partnerships, limited liability companies and S corporations.

As you know, conversion from a C corporation to an entity subject to a single level of tax is a taxable event under current law. Moreover, due to restrictions imposed on S corporations, older employee-owned businesses must remain as regular C corporations. Thus, many long-established private, employee-owned companies remain locked in Subchapter C where they are subject to a double layer of tax on their earnings. Had President Bush's proposal to eliminate the double taxation of corporate earnings been enacted into law, this disparity would have been eliminated and all entities would have been subject to only one level of tax.

In 1996 as part of the Small Business Job Protection Act the Congress enabled certain tax-exempt entities, including Employee Stock Ownership Plans (ESOPs) to be S corporation shareholders. In explaining the reason for this change, the Congress stated:

> "The Congress believed that the present-law prohibition of certain tax-exempt organizations being S corporation shareholders may have inhibited employee ownership of closely-held businesses, frustrated estate planning, discouraged charitable giving, and restricted sources of capital for closely-held businesses. The Congress

sought to lift these barriers by allowing certain tax-exempt organizations to be shareholders in S corporations."[1]

As Congress again looks to modernize Subchapter S, we believe that you should consider changes to the current limitations with respect to eligible shareholders that will further the goals of broad employee ownership and access to capital for closely held businesses. In particular, we suggest a change in the law to permit all active employees and directors who own common stock in an employee-owned regular C corporation to be considered as one shareholder.

Relaxing the limit on the number of shareholders in the case of employee-owned S corporations will help align employees' interests with that of the business, thus dramatically improving employee retention, moral, loyalty, productivity and prosperity. We urge the members of the subcommittee to consider the benefits of allowing employee-owned companies greater access to Subchapter S and to include such a proposal in appropriate legislation. We would be pleased to work with you and your colleagues on these important issues.

Thank for your time and consideration.

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[1] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104*th Congress (JCS–12–6), December 18, 1996, p. 130.