Comments

on

behalf of the

American Bar Association
Section of Taxation

to the

House Subcommittee on Select Revenue Measures

of the

House Ways and Means Committee

on the subject of

The Subchapter S Modernization Act Of 2003

July 1, 2003
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.


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 effect for the first taxable year beginning after 1996.

• 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 carryforwards 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:

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</tr>
<tr>
<td>Inventory (2)</td>
<td>2,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td><strong>$5,000,000</strong></td>
<td><strong>$4,000,000</strong></td>
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A, X’s sole shareholder, has $6,000,000 basis in his S corporation stock.
On liquidation of X -

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<table>
<thead>
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<tbody>
<tr>
<td>Land</td>
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<tr>
<td>Inventory (1)</td>
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<td>ordinary income</td>
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<tr>
<td>Inventory (2)</td>
<td>(  1,000,000)</td>
<td>ordinary loss</td>
</tr>
<tr>
<td>TOTAL</td>
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<td></td>
</tr>
</tbody>
</table>

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 provisions 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 affect. 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 taxable year for which the S corporation or qualified subchapter S subsidiary election becomes effective, 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 or 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 (Corp1) 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 not 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. 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

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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).
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 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

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\(^2\) Former Reg. § 1.1502-13(c)(6).

\(^3\) 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).
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 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 – Distributions 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).