

103^D CONGRESS
2^D SESSION

H. R. 4056

To amend the Internal Revenue Code of 1986 to reform the rules regarding subchapter S corporations.

IN THE HOUSE OF REPRESENTATIVES

MARCH 16, 1994

Mr. HOAGLAND (for himself, Mr. KOPETSKI, Mr. BREWSTER, Mr. ARCHER, Mr. SHAW, Mr. PORTMAN, and Mr. MATSUI) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to reform the rules regarding subchapter S corporations.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE;**

4 **TABLE OF CONTENTS.**

5 (a) **SHORT TITLE.**—This Act may be cited as the
6 “S Corporation Reform Act of 1993”.

7 (b) **AMENDMENT OF 1986 CODE.**—Except as other-
8 wise expressly provided, whenever in this Act an amend-
9 ment or repeal is expressed in terms of an amendment
10 to, or repeal of, a section or other provision, the reference

1 shall be considered to be made to a section or other provi-
 2 sion of the Internal Revenue Code of 1986.

3 (c) TABLE OF CONTENTS.—The table of contents of
 4 this Act is as follows:

Sec. 1. Short title; amendment of 1986 Code; table of contents.

TITLE I—ELIGIBLE SHAREHOLDERS OF S CORPORATION

Subtitle A—Number of Shareholders

Sec. 101. S corporations permitted to have 50 shareholders.

Sec. 102. Members of family treated as 1 shareholder.

Subtitle B—Persons Allowed as Shareholders

Sec. 111. Certain exempt organizations.

Sec. 112. Financial institutions.

Sec. 113. Nonresident aliens.

Sec. 114. Electing small business trusts.

Subtitle C—Other Provisions

Sec. 121. Expansion of post-death qualification for certain trusts.

TITLE II—QUALIFICATION AND ELIGIBILITY REQUIREMENTS FOR S CORPORATIONS

Subtitle A—One Class of Stock

Sec. 201. Issuance of preferred stock permitted.

Sec. 202. Financial institutions permitted to hold safe harbor debt.

Subtitle B—Elections and Terminations

Sec. 211. Rules relating to inadvertent terminations and invalid elections.

Sec. 212. Agreement to terminate year.

Sec. 213. Expansion of post-termination transition period.

Sec. 214. Repeal of excessive passive investment income as a termination event.

Subtitle C—Other Provisions

Sec. 221. S corporations permitted to hold subsidiaries.

Sec. 222. C corporation rules to apply for fringe benefit purposes.

Sec. 223. Treatment of distributions during loss years.

Sec. 224. Consent dividend for AAA bypass election.

Sec. 225. Treatment of S corporations under subchapter C.

Sec. 226. Elimination of pre-1983 earnings and profits.

Sec. 227. Allowance of charitable contributions of inventory and scientific
property.

TITLE III—TAXATION OF S CORPORATION SHAREHOLDERS

Sec. 301. Uniform treatment of owner-employees under prohibited transaction
rules.

Sec. 302. Treatment of losses to shareholders.

TITLE IV—EFFECTIVE DATE

Sec. 401. Effective date.

1 TITLE I—ELIGIBLE SHAREHOLD-
2 ERS OF S CORPORATION
3 Subtitle A—Number of
4 Shareholders

5 SEC. 101. S CORPORATIONS PERMITTED TO HAVE 50
6 SHAREHOLDERS.

7 Subparagraph (A) of section 1361(b)(1) (defining
 8 small business corporation) is amended by striking “35
 9 shareholders” and inserting “50 shareholders”.

10 SEC. 102. MEMBERS OF FAMILY TREATED AS 1 SHARE-
11 HOLDER.

12 Paragraph (1) of section 1361(c) (relating to special
 13 rules for applying subsection (b)) is amended to read as
 14 follows:

15 “(1) MEMBERS OF FAMILY TREATED AS 1
 16 SHAREHOLDER.—

17 “(A) IN GENERAL.—For purposes of sub-
 18 section (b)(1)(A)—

19 “(i) except as provided in clause (ii),
 20 a husband and wife (and their estates)
 21 shall be treated as 1 shareholder, and

22 “(ii) in the case of a family with re-
 23 spect to which an election is in effect

1 under subparagraph (E), all members of
2 the family shall be treated as 1 share-
3 holder.

4 “(B) MEMBERS OF THE FAMILY.—For
5 purposes of subparagraph (A)(ii), the term
6 ‘members of the family’ means the lineal de-
7 scendants of the common ancestor and the
8 spouses (or former spouses) of such lineal de-
9 scendants or common ancestor.

10 “(C) COMMON ANCESTOR.—For purposes
11 of this paragraph, an individual shall not be
12 considered a common ancestor if, as of the later
13 of the effective date of this paragraph or the
14 time the election under section 1362(a) is
15 made, the individual is more than 6 generations
16 removed from the youngest generation of share-
17 holders.

18 “(D) EFFECT OF ADOPTION, ETC.—In de-
19 termining whether any relationship specified in
20 subparagraph (B) or (C) exists, the rules of
21 section 152(b)(2) shall apply.

22 “(E) ELECTION.—An election under sub-
23 paragraph (A)(ii)—

24 “(i) must be made with the consent of
25 all shareholders,

1 “(ii) shall remain in effect until termi-
2 nated, and

3 “(iii) shall apply only with respect to
4 1 family in any corporation.”

5 **Subtitle B—Persons Allowed as**
6 **Shareholders**

7 **SEC. 111. CERTAIN EXEMPT ORGANIZATIONS.**

8 (a) CERTAIN EXEMPT ORGANIZATIONS ALLOWED TO
9 BE SHAREHOLDERS.—

10 (1) IN GENERAL.—Subparagraph (B) of section
11 1361(b)(1) (defining small business corporation) is
12 amended to read as follows:

13 “(B) have as a shareholder a person (other
14 than an estate, a trust described in subsection
15 (c)(2), or an organization described in sub-
16 section (c)(7)) who is not an individual,”.

17 (2) ELIGIBLE EXEMPT ORGANIZATIONS.—Sec-
18 tion 1361(c) (relating to special rules for applying
19 subsection (b)) is amended by adding at the end the
20 following new paragraph:

21 “(7) CERTAIN EXEMPT ORGANIZATIONS PER-
22 Mitted AS SHAREHOLDERS.—For purposes of sub-
23 section (b)(1)(B), an organization described in sec-
24 tion 401(a) or 501(c)(3) may be a shareholder in an
25 S corporation.”.

1 (b) CONTRIBUTIONS OF S CORPORATION STOCK.—
2 Section 170(e)(1) (relating to certain contributions of or-
3 dinary income and capital gain property) is amended by
4 adding at the end the following sentence: “For purposes
5 of applying this paragraph in the case of a charitable con-
6 tribution of stock in an S corporation, rules similar to the
7 rules of section 751 shall apply in determining whether
8 gain on such stock would have been long-term capital gain
9 if such stock were sold by the taxpayer.”

10 (c) SPECIAL RULES APPLICABLE TO PARTNERSHIPS
11 AND S CORPORATIONS.—

12 (1) IN GENERAL.—Subsection (c) of section
13 512 (relating to unrelated business tax income) is
14 amended—

15 (A) by inserting “or S corporation” after
16 “partnership” each place it appears in para-
17 graphs (1) and (3),

18 (B) by inserting “or shareholder” after
19 “member” in paragraph (1), and

20 (C) by inserting “AND S CORPORATIONS”
21 after “PARTNERSHIPS” in the heading.

22 (2) REPORTING REQUIREMENT.—Section 6037
23 (relating to return of S corporation) is amended by
24 adding at the end the following new subsection:

1 “(c) SEPARATE STATEMENT OF ITEMS OF UNRE-
 2 LATED BUSINESS TAXABLE INCOME.—In the case of any
 3 S corporation regularly carrying on a trade or business
 4 (within the meaning of section 512(c)(1)), the information
 5 required under subsection (b) to be furnished to any
 6 shareholder described in section 1361(c)(7) shall include
 7 such information as is necessary to enable the shareholder
 8 to compute its pro rata share of the corporation’s income
 9 or loss from the trade or business in accordance with sec-
 10 tion 512(a)(1), but without regard to the modifications de-
 11 scribed in paragraphs (8) through (15) of section 512(b).”

12 **SEC. 112. FINANCIAL INSTITUTIONS.**

13 Subparagraph (B) of section 1361(b)(2) (defining in-
 14 eligible corporation) is amended to read as follows:

15 “(B) a financial institution which uses the
 16 reserve method of accounting for bad debts de-
 17 scribed in section 585 or 593,”.

18 **SEC. 113. NONRESIDENT ALIENS.**

19 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-
 20 HOLDERS.—

21 (1) IN GENERAL.—Paragraph (1) of section
 22 1361(b) (defining small business corporation) is
 23 amended—

24 (A) by adding “and” at the end of sub-
 25 paragraph (B),

1 (B) by striking subparagraph (C), and
2 (C) by redesignating subparagraph (D) as
3 subparagraph (C).

4 (2) CONFORMING AMENDMENTS.—Paragraphs
5 (4) and (5)(A) of section 1361(c) (relating to special
6 rules for applying subsection (b)) are each amended
7 by striking “subsection (b)(1)(D)” and inserting
8 “subsection (b)(1)(C)”.

9 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED
10 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED
11 STATES.—

12 (1) IN GENERAL.—Section 875 is amended—

13 (A) by striking “and” at the end of para-
14 graph (1),

15 (B) by striking the period at the end of
16 paragraph (2) and inserting “, and”, and

17 (C) by adding at the end the following new
18 paragraph:

19 “(3) a nonresident alien individual shall be con-
20 sidered as being engaged in a trade or business
21 within the United States if the S corporation of
22 which such individual is a shareholder is so en-
23 gaged.”

24 (2) APPLICATION OF WITHHOLDING TAX ON
25 NONRESIDENT ALIEN SHAREHOLDERS.—Section

1 1446 (relating to withholding tax on foreign part-
2 ners' share of effectively connected income) is
3 amended by redesignating subsection (f) as sub-
4 section (g) and by inserting after subsection (e) the
5 following new subsection:

6 “(f) S CORPORATION TREATED AS PARTNERSHIP,
7 ETC.—For purposes of this section—

8 “(1) an S corporation shall be treated as a
9 partnership,

10 “(2) the shareholders of such corporation shall
11 be treated as partners of such partnership, and

12 “(3) any reference to section 704 shall be treat-
13 ed as a reference to section 1366.”

14 (3) CONFORMING AMENDMENTS.—

15 (A) The heading of section 875 is amended
16 to read as follows:

17 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**
18 **AND TRUSTS; S CORPORATIONS.”**

19 (B) The heading of section 1446 is amend-
20 ed to read as follows:

21 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**
22 **AND S CORPORATE SHAREHOLDERS’ SHARE**
23 **OF EFFECTIVELY CONNECTED INCOME.”**

24 (4) CLERICAL AMENDMENTS.—

1 (A) The item relating to section 875 in the
2 table of sections for subpart A of part II of
3 subchapter N of chapter 1 is amended to read
4 as follows:

“Sec. 875. Partnerships; beneficiaries of estates and trusts; S corporations.”

5 (B) The item relating to section 1446 in
6 the table of sections for subchapter A of chap-
7 ter 3 is amended to read as follows:

“Sec. 1446. Withholding tax on foreign partners’ and S corporate shareholders’
share of effectively connected income.”

8 (c) PERMANENT ESTABLISHMENT OF PARTNERS
9 AND S CORPORATION SHAREHOLDERS.—Section 894 (re-
10 lating to income affected by treaty) is amended by adding
11 at the end the following new subsection:

12 “(c) PERMANENT ESTABLISHMENT OF PARTNERS
13 AND S CORPORATION SHAREHOLDERS.—If a partnership
14 or S corporation has a permanent establishment in the
15 United States (within the meaning of a treaty to which
16 the United States is a party) at any time during a taxable
17 year of such entity, a nonresident alien individual or for-
18 eign corporation which is a partner in such partnership,
19 or a nonresident alien individual who is a shareholder in
20 such S corporation, shall be treated as having a permanent
21 establishment in the United States for purposes of such
22 treaty.”

1 **SEC. 114. ELECTING SMALL BUSINESS TRUSTS.**

2 (a) GENERAL RULE.—Subparagraph (A) of section
3 1361(c)(2) (relating to certain trusts permitted as share-
4 holders) is amended by inserting after clause (iv) the fol-
5 lowing new clause:

6 “(v) An electing small business trust.”

7 (b) CURRENT BENEFICIARIES TREATED AS SHARE-
8 HOLDERS.—Subparagraph (B) of section 1361(c)(2) is
9 amended by adding at the end the following new clause:

10 “(v) In the case of a trust described
11 in clause (v) of subparagraph (A), each po-
12 tential current beneficiary of such trust
13 shall be treated as a shareholder; except
14 that, if for any period there is no potential
15 current beneficiary of such trust, such
16 trust shall be treated as the shareholder
17 during such period.”

18 (c) ELECTING SMALL BUSINESS TRUST DEFINED.—
19 Section 1361 (defining S corporation) is amended by add-
20 ing at the end the following new subsection:

21 “(e) ELECTING SMALL BUSINESS TRUST DE-
22 FINED.—

23 “(1) ELECTING SMALL BUSINESS TRUST.—For
24 purposes of this section—

1 “(A) IN GENERAL.—Except as provided in
2 subparagraph (B), the term ‘electing small
3 business trust’ means any trust if—

4 “(i) such trust does not have as a
5 beneficiary any person other than an indi-
6 vidual, an estate, or an organization de-
7 scribed in section 401(a) or 501(c)(3),

8 “(ii) no interest in such trust was ac-
9 quired by purchase, and

10 “(iii) an election under this subsection
11 applies to such trust.

12 “(B) CERTAIN TRUSTS NOT ELIGIBLE.—
13 The term ‘electing small business trust’ shall
14 not include—

15 “(i) any qualified subchapter S trust
16 (as defined in subsection (d)(3)) if an elec-
17 tion under subsection (d)(2) applies to any
18 corporation the stock of which is held by
19 such trust, and

20 “(ii) any trust exempt from tax under
21 this subtitle.

22 “(C) PURCHASE.—For purposes of sub-
23 paragraph (A), the term ‘purchase’ means any
24 acquisition if the basis of the property acquired
25 is determined under section 1012.

1 “(2) POTENTIAL CURRENT BENEFICIARY.—For
2 purposes of this section, the term ‘potential current
3 beneficiary’ means, with respect to any period, any
4 person who at any time during such period is enti-
5 tled to, or at the discretion of any person may re-
6 ceive, a distribution from the principal or income of
7 the trust. If a trust disposes of all of the stock which
8 it holds in an S corporation, then, with respect to
9 such corporation, the term ‘potential current bene-
10 ficiary’ does not include any person who first met
11 the requirements of the preceding sentence during
12 the 60-day period ending on the date of such dis-
13 position.

14 “(3) ELECTION.—An election under this sub-
15 section shall be made by the trustee in such manner
16 and form, and at such time, as the Secretary may
17 prescribe. Any such election shall apply to the tax-
18 able year of the trust for which made and all subse-
19 quent taxable years of such trust unless revoked
20 with the consent of the Secretary.

21 “(4) CROSS REFERENCE.—

**“For special treatment of electing small business
 trusts, see section 641(d).”**

22 (d) TAXATION OF ELECTING SMALL BUSINESS
23 TRUSTS.—Section 641 (relating to imposition of tax on

1 trusts) is amended by adding at the end the following new
2 subsection:

3 “(d) SPECIAL RULES FOR TAXATION OF ELECTING
4 SMALL BUSINESS TRUSTS.—

5 “(1) IN GENERAL.—For purposes of this chap-
6 ter—

7 “(A) the portion of any electing small busi-
8 ness trust which consists of stock in 1 or more
9 S corporations shall be treated as a separate
10 trust, and

11 “(B) the amount of the tax imposed by
12 this chapter on such separate trust shall be de-
13 termined with the modifications of paragraph
14 (2).

15 “(2) MODIFICATIONS.—For purposes of para-
16 graph (1), the modifications of this paragraph are
17 the following:

18 “(A) Except as provided in section 1(h),
19 the amount of the tax imposed by section 1(e)
20 shall be determined by using the highest rate of
21 tax set forth in section 1(e).

22 “(B) The exemption amount under section
23 55(d) shall be zero.

1 “(C) The only items of income, loss, deduc-
2 tion, or credit to be taken into account are the
3 following:

4 “(i) The items required to be taken
5 into account under section 1366.

6 “(ii) Any gain or loss from the dis-
7 position of stock in an S corporation.

8 “(iii) To the extent provided in regu-
9 lations, State or local income taxes or ad-
10 ministrative expenses to the extent alloca-
11 ble to items described in clauses (i) and
12 (ii).

13 No deduction or credit shall be allowed for any
14 amount not described in this paragraph, and no
15 item described in this paragraph shall be appor-
16 tioned to any beneficiary.

17 “(D) No amount shall be allowed under
18 paragraph (1) or (2) of section 1211(b).

19 “(3) TREATMENT OF REMAINDER OF TRUST
20 AND DISTRIBUTIONS.—For purposes of determin-
21 ing—

22 “(A) the amount of the tax imposed by
23 this chapter on the portion of any electing small
24 business trust not treated as a separate trust
25 under paragraph (1), and

1 “(B) the distributable net income of the
 2 entire trust,
 3 the items referred to in paragraph (2)(C) shall be
 4 excluded. Except as provided in the preceding sen-
 5 tence, this subsection shall not affect the taxation of
 6 any distribution from the trust.

7 “(4) TREATMENT OF UNUSED DEDUCTIONS
 8 WHERE TERMINATION OF SEPARATE TRUST.—If a
 9 portion of an electing small business trust ceases to
 10 be treated as a separate trust under paragraph (1),
 11 any carryover or excess deduction of the separate
 12 trust which is referred to in section 642(h) shall be
 13 taken into account by the entire trust.

14 “(5) ELECTING SMALL BUSINESS TRUST.—For
 15 purposes of this subsection, the term ‘electing small
 16 business trust’ has the meaning given such term by
 17 section 1361(e)(1).”

18 **Subtitle C—Other Provisions**

19 **SEC. 121. EXPANSION OF POST-DEATH QUALIFICATION FOR** 20 **CERTAIN TRUSTS.**

21 Subparagraph (A) of section 1361(c)(2) (relating to
 22 certain trusts permitted as shareholders) is amended—

23 (1) by striking “60-day period” each place it
 24 appears in clauses (ii) and (iii) and inserting “2-year
 25 period”, and

1 (2) by striking the last sentence in clause (ii).

2 **TITLE II—QUALIFICATION AND**
 3 **ELIGIBILITY REQUIREMENTS**
 4 **FOR S CORPORATIONS**
 5 **Subtitle A—One Class of Stock**

6 **SEC. 201. ISSUANCE OF PREFERRED STOCK PERMITTED.**

7 (a) IN GENERAL.—Section 1361(c), as amended by
 8 section 111(a)(2), is amended by adding at the end the
 9 following new paragraph:

10 “(8) TREATMENT OF QUALIFIED PREFERRED
 11 STOCK.—

12 “(A) IN GENERAL.—Notwithstanding sub-
 13 section (b)(1)(D), an S corporation may issue
 14 qualified preferred stock.

15 “(B) QUALIFIED PREFERRED STOCK DE-
 16 FINED.—For purposes of this paragraph, the
 17 term ‘qualified preferred stock’ means stock de-
 18 scribed in section 1504(a)(4) which is issued to
 19 a person eligible to hold common stock of an S
 20 corporation.

21 “(C) DISTRIBUTIONS.—A distribution (not
 22 in part or full payment in exchange for stock)
 23 made by the corporation with respect to quali-
 24 fied preferred stock shall be includible as inter-
 25 est income of the holder and deductible to the

1 corporation as interest expense in computing
2 taxable income under section 1363(b) in the
3 year such distribution is received.”

4 (b) CONFORMING AMENDMENTS.—

5 (1) Subparagraph (C) of section 1361(b)(1), as
6 redesignated by section 113(a)(1)(C), is amended by
7 inserting “except as provided in paragraph (8),” be-
8 fore “have”.

9 (2) Subsection (a) of section 1366 is amended
10 by adding at the end the following new paragraph:

11 “(3) ALLOCATION WITH RESPECT TO QUALI-
12 FIED PREFERRED STOCK.—The holders of qualified
13 preferred stock shall not, with respect to such stock,
14 be allocated any of the items described in paragraph
15 (1).”

16 **SEC. 202. FINANCIAL INSTITUTIONS PERMITTED TO HOLD**
17 **SAFE HARBOR DEBT.**

18 Subparagraph (B) of section 1361(c)(5) (defining
19 straight debt) is amended by adding “and” at the end of
20 clause (i) and by striking clauses (ii) and (iii) and insert-
21 ing the following:

22 “(ii) in any case in which the terms of
23 such promise include a provision under
24 which the obligation to pay may be con-
25 verted (directly or indirectly) into stock of

the corporation, such terms, taken as a whole, are substantially the same as the terms which could have been obtained on the effective date of the promise from a person which is not a related person (within the meaning of section 465(b)(3)(C)) to the S corporation or its shareholders, and

“(iii) the creditor is—

“(I) an individual,

“(II) an estate,

“(III) a trust described in paragraph (2), or

“(IV) a person which is actively and regularly engaged in the business of lending money.”

Subtitle B—Elections and Terminations

SEC. 211. RULES RELATING TO INADVERTENT TERMINATIONS AND INVALID ELECTIONS.

(a) GENERAL RULE.—Subsection (f) of section 1362 (relating to inadvertent terminations) is amended to read as follows:

“(f) INADVERTENT INVALID ELECTIONS OR TERMINATIONS.—If—

1 “(1) an election under subsection (a) by any
2 corporation—

3 “(A) was not effective for the taxable year
4 for which made (determined without regard to
5 subsection (b)(2)) by reason of a failure to meet
6 the requirements of section 1361(b) or to ob-
7 tain shareholder consents, or

8 “(B) was terminated under paragraph (2)
9 of subsection (d),

10 “(2) the Secretary determines that the cir-
11 cumstances resulting in such ineffectiveness or ter-
12 mination were inadvertent,

13 “(3) no later than a reasonable period of time
14 after discovery of the circumstances resulting in
15 such ineffectiveness or termination, steps were
16 taken—

17 “(A) so that the corporation is a small
18 business corporation, or

19 “(B) to acquire the required shareholder
20 consents, and

21 “(4) the corporation, and each person who was
22 a shareholder in the corporation at any time during
23 the period specified pursuant to this subsection,
24 agrees to make such adjustments (consistent with
25 the treatment of the corporation as an S corpora-

1 tion) as may be required by the Secretary with re-
2 spect to such period,
3 then, notwithstanding the circumstances resulting in such
4 ineffectiveness or termination, such corporation shall be
5 treated as an S corporation during the period specified
6 by the Secretary.”

7 (b) LATE ELECTIONS.—Subsection (b) of section
8 1362 is amended by adding at the end thereof the follow-
9 ing new paragraph:

10 “(5) AUTHORITY TO TREAT LATE ELECTIONS
11 AS TIMELY.—If—

12 “(A) an election under subsection (a) is
13 made for any taxable year (determined without
14 regard to paragraph (3)) after the date pre-
15 scribed by this subsection for making such elec-
16 tion for such taxable year, and

17 “(B) the Secretary determines that there
18 was reasonable cause for the failure to timely
19 make such election,

20 the Secretary may treat such election as timely
21 made for such taxable year (and paragraph (3) shall
22 not apply).”

23 (c) AUTOMATIC WAIVERS.—The Secretary of the
24 Treasury shall provide for an automatic waiver procedure
25 under section 1362(f) of the Internal Revenue Code of

1 1986 in cases in which the Secretary determines appro-
2 priate.

3 (d) EFFECTIVE DATE.—The amendments made by
4 subsection (a) and (b) shall apply with respect to elections
5 for taxable years beginning after December 31, 1982.

6 **SEC. 212. AGREEMENT TO TERMINATE YEAR.**

7 Paragraph (2) of section 1377(a) (relating to pro
8 rata share) is amended to read as follows:

9 “(2) ELECTION TO TERMINATE YEAR.—

10 “(A) IN GENERAL.—Under regulations
11 prescribed by the Secretary, if any shareholder
12 terminates the shareholder’s interest in the cor-
13 poration during the taxable year and all af-
14 fected shareholders agree to the application of
15 this paragraph, paragraph (1) shall be applied
16 to the affected shareholders as if the taxable
17 year consisted of 2 taxable years the first of
18 which ends on the date of the termination.

19 “(B) AFFECTED SHAREHOLDERS.—For
20 purposes of subparagraph (A), the term ‘af-
21 fected shareholders’ means the shareholder
22 whose interest is terminated and all sharehold-
23 ers to whom such shareholder has transferred
24 shares during the taxable year. If such share-
25 holder has transferred shares to the corpora-

1 tion, the term ‘affected shareholders’ shall in-
2 clude all persons who are shareholders during
3 the taxable year.”

4 **SEC. 213. EXPANSION OF POST-TERMINATION TRANSITION**
5 **PERIOD.**

6 (a) **IN GENERAL.**—Paragraph (1) of section 1377(b)
7 (relating to post-termination transition period) is amended
8 by striking “and” at the end of subparagraph (A), by re-
9 designating subparagraph (B) as subparagraph (C), and
10 by inserting after subparagraph (A) the following new sub-
11 paragraph:

12 “(B) the 120-day period beginning on the
13 date of any determination pursuant to an audit
14 of the taxpayer which follows the termination of
15 the corporation’s election and which adjusts a
16 subchapter S item of income, loss, or deduction
17 of the corporation arising during the S period
18 (as defined in section 1368(e)(2)), and”.

19 (b) **DETERMINATION DEFINED.**—Paragraph (2) of
20 section 1377(b) is amended by striking subparagraphs (A)
21 and (B), by redesignating subparagraph (C) as subpara-
22 graph (B), and by inserting before subparagraph (B) (as
23 so redesignated) the following new subparagraph:

24 “(A) a determination as defined in section
25 1313(a), or”.

1 (c) REPEAL OF SPECIAL AUDIT PROVISIONS FOR
2 SUBCHAPTER S ITEMS.—

3 (1) GENERAL RULE.—Subchapter D of chapter
4 63 (relating to tax treatment of subchapter S items)
5 is hereby repealed.

6 (2) CONSISTENT TREATMENT REQUIRED.—Sec-
7 tion 6037 (relating to return of S corporation), as
8 amended by section 111(c)(2), is amended by adding
9 at the end the following new subsection:

10 “(d) SHAREHOLDER’S RETURN MUST BE CONSIST-
11 ENT WITH CORPORATE RETURN OR SECRETARY NOTI-
12 FIED OF INCONSISTENCY.—

13 “(1) IN GENERAL.—A shareholder of an S cor-
14 poration shall, on such shareholder’s return, treat a
15 subchapter S item in a manner which is consistent
16 with the treatment of such item on the corporate
17 return.

18 “(2) NOTIFICATION OF INCONSISTENT TREAT-
19 MENT.—

20 “(A) IN GENERAL.—In the case of any
21 subchapter S item, if—

22 “(i)(I) the corporation has filed a re-
23 turn but the shareholder’s treatment on
24 his return is (or may be) inconsistent with

1 the treatment of the item on the corporate
2 return, or

3 “(II) the corporation has not filed a
4 return, and

5 “(ii) the shareholder files with the
6 Secretary a statement identifying the in-
7 consistency,

8 paragraph (1) shall not apply to such item.

9 “(B) SHAREHOLDER RECEIVING INCOR-
10 RECT INFORMATION.—A shareholder shall be
11 treated as having complied with clause (ii) of
12 subparagraph (A) with respect to a subchapter
13 S item if the shareholder—

14 “(i) demonstrates to the satisfaction
15 of the Secretary that the treatment of the
16 subchapter S item on the shareholder’s re-
17 turn is consistent with the treatment of the
18 item on the schedule furnished to the
19 shareholder by the corporation, and

20 “(ii) elects to have this paragraph
21 apply with respect to that item.

22 “(3) EFFECT OF FAILURE TO NOTIFY.—In any
23 case—

24 “(A) described in subparagraph (A)(i)(I)
25 of paragraph (2), and

1 “(B) in which the shareholder does not
 2 comply with subparagraph (A)(ii) of paragraph
 3 (2),

4 any adjustment required to make the treatment of
 5 the items by such shareholder consistent with the
 6 treatment of the items on the corporate return shall
 7 be treated as arising out of mathematical or clerical
 8 errors and assessed according to section 6213(b)(1).
 9 Paragraph (2) of section 6213(b) shall not apply
 10 to any assessment referred to in the preceding
 11 sentence.

12 “(4) SUBCHAPTER S ITEM.—For purposes of
 13 this subsection, the term ‘subchapter S item’ means
 14 any item of an S corporation to the extent that reg-
 15 ulations prescribed by the Secretary provide that, for
 16 purposes of this subtitle, such item is more appro-
 17 priately determined at the corporation level than at
 18 the shareholder level.

19 “(5) ADDITION TO TAX FOR FAILURE TO COM-
 20 PLY WITH SECTION.—

**“For addition to tax in the case of a shareholder’s
 negligence in connection with, or disregard of, the
 requirements of this section, see part II of sub-
 chapter A of chapter 68.”**

21 (3) CONFORMING AMENDMENTS.—

22 (A) Section 1366 is amended by striking
 23 subsection (g).

1 (B) Subsection (b) of section 6233 is
2 amended to read as follows:

3 “(b) SIMILAR RULES IN CERTAIN CASES.—If a part-
4 nership return is filed for any taxable year but it is deter-
5 mined that there is no entity for such taxable year, to the
6 extent provided in regulations, rules similar to the rules
7 of subsection (a) shall apply.”

8 (C) The table of subchapters for chapter
9 63 is amended by striking the item relating to
10 subchapter D.

11 **SEC. 214. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**
12 **COME AS A TERMINATION EVENT.**

13 (a) IN GENERAL.—Section 1362(d) (relating to ter-
14 mination) is amended by striking paragraph (3).

15 (b) MODIFICATION OF TAX IMPOSED ON EXCESSIVE
16 PASSIVE INVESTMENT INCOME.—

17 (1) INCREASE IN THRESHOLD.—Subsections
18 (a)(2) and (b)(1)(A)(i) of section 1375 (relating to
19 tax imposed when passive investment income of cor-
20 poration having subchapter C earnings and profits
21 exceeds 25 percent of gross receipts) are each
22 amended by striking “25 percent” and inserting “50
23 percent”.

24 (2) TAX RATE INCREASE AFTER THIRD CON-
25 SECUTIVE YEAR.—Section 1375 is amended by re-

1 designating subsections (c) and (d) as subsections
 2 (d) and (e), respectively, and by inserting after sub-
 3 section (b) the following new subsection:

4 “(c) TAX RATE INCREASE AFTER THIRD CONSECU-
 5 TIVE YEAR.—

6 “(1) IN GENERAL.—If an S corporation is de-
 7 scribed in subsection (a) for more than 3 consecutive
 8 taxable years, then the rate of tax imposed under
 9 subsection (a) with respect to each succeeding con-
 10 secutive taxable year (if any) shall be determined
 11 under the following table:

The rate of tax imposed under subsection (a) shall be equal to such rate of tax for the 3rd taxable year, plus the following percentage points:	
“In the case of the—	
4th taxable year	10
5th taxable year	20
6th taxable year	30
7th taxable year	40
8th taxable year and thereafter	50.

12 “(2) YEARS TAKEN INTO ACCOUNT.—No tax
 13 shall be increased under paragraph (1) for any tax-
 14 able year beginning before January 1, 1994.”

15 (c) CONFORMING AMENDMENTS.—

16 (1) Section 1362(f)(1) is amended by striking
 17 “or (3)”.

18 (2) Subsection (b) of section 1375 is amended
 19 by striking paragraphs (3) and (4) and inserting the
 20 following new paragraphs:

1 “(3) SUBCHAPTER C EARNINGS AND PROF-
2 ITS.—The term ‘subchapter C earnings and profits’
3 means earnings and profits of any corporation for
4 any taxable year with respect to which an election
5 under section 1362(a) (or under section 1372 of
6 prior law) was not in effect.

7 “(4) GROSS RECEIPTS FROM SALES OF CAPITAL
8 ASSETS (OTHER THAN STOCK AND SECURITIES).—In
9 the case of dispositions of capital assets (other than
10 stock and securities), gross receipts from such dis-
11 positions shall be taken into account only to the ex-
12 tent of the capital gain net income therefrom.

13 “(5) PASSIVE INVESTMENT INCOME DE-
14 FINED.—

15 “(A) IN GENERAL.—Except as otherwise
16 provided in this paragraph, the term ‘passive
17 investment income’ means gross receipts de-
18 rived from royalties, rents, dividends, interest,
19 and annuities.

20 “(B) EXCEPTION FOR INTEREST ON
21 NOTES FROM SALES OF INVENTORY.—The term
22 ‘passive investment income’ shall not include in-
23 terest on any obligation acquired in the ordi-
24 nary course of the corporation’s trade or busi-

1 ness from its sale of property described in sec-
2 tion 1221(1).

3 “(C) TREATMENT OF CERTAIN LENDING
4 OR FINANCE COMPANIES.—If the S corporation
5 meets the requirements of section 542(c)(6) for
6 the taxable year, the term ‘passive investment
7 income’ shall not include gross receipts for the
8 taxable year which are derived directly from the
9 active and regular conduct of a lending or fi-
10 nance business (as defined in section
11 542(d)(1)).

12 “(D) SPECIAL RULE FOR OPTIONS AND
13 COMMODITY DEALINGS.—

14 “(i) IN GENERAL.—In the case of any
15 options dealer or commodities dealer, pas-
16 sive investment income shall be determined
17 by not taking into account any gain or loss
18 (in the normal course of the taxpayer’ ac-
19 tivity of dealing in or trading section 1256
20 contracts) from any section 1256 contract
21 or property related to such a contract.

22 “(ii) DEFINITIONS.—For purposes of
23 this subparagraph—

24 “(I) OPTIONS DEALER.—The
25 term ‘options dealer’ has the meaning

1 given such term by section
2 1256(g)(8).

3 “(II) COMMODITIES DEALER.—

4 The term ‘commodities dealer’ means
5 a person who is actively engaged in
6 trading section 1256 contracts and is
7 registered with a domestic board of
8 trade which is designated as a con-
9 tract market by the Commodities Fu-
10 tures Trading Commission.

11 “(III) SECTION 1256 CON-
12 TRACT.—The term ‘section 1256 con-
13 tract’ has the meaning given to such
14 term by section 1256(b).

15 “(E) COORDINATION WITH SECTION
16 1374.—The amount of passive investment in-
17 come shall be determined by not taking into ac-
18 count any recognized built-in gain or loss of the
19 S corporation for any taxable year in the rec-
20 ognition period. Terms used in the preceding
21 sentence shall have the same respective mean-
22 ing as when used in section 1374.”

23 (3) The heading for section 1375 is amended by
24 striking “25” and inserting “50”.

1 (4) The table of sections for part III of sub-
 2 chapter S of chapter 1 is amended by striking “25”
 3 in the item relating to section 1375 and inserting
 4 “50”.

5 (5) Clause (i) of section 1042(c)(4)(A) is
 6 amended by striking “section 1362(d)(3)(D)” and
 7 inserting “section 1375(b)(5)”.

8 **Subtitle C—Other Provisions**

9 **SEC. 221. S CORPORATIONS PERMITTED TO HOLD SUBSIDI-** 10 **ARIES.**

11 (a) IN GENERAL.—Paragraph (2) of section 1361(b)
 12 (defining ineligible corporation) is amended by striking
 13 subparagraph (A) and by redesignating subparagraphs
 14 (B), (C), (D), and (E) as subparagraphs (A), (B), (C),
 15 and (D), respectively.

16 (b) CERTAIN DIVIDENDS NOT TREATED AS PASSIVE
 17 INVESTMENT INCOME.—Section 1375(b)(5) (defining pas-
 18 sive investment income), as added by section 214(c)(2),
 19 is amended by adding at the end the following new sub-
 20 paragraph:

21 “(F) TREATMENT OF CERTAIN DIVI-
 22 DENDS.—If an S corporation holds stock in a
 23 C corporation meeting the requirements of sec-
 24 tion 1504(a)(2), the term ‘passive investment
 25 income’ shall not include dividends from such C

1 corporation to the extent such dividends are at-
2 tributable to the earnings and profits of such C
3 corporation derived from the active conduct of
4 a trade or business.”

5 (c) CONFORMING AMENDMENTS.—

6 (1) Subsection (c) of section 1361, as amended
7 by sections 111 and 201, is amended by striking
8 paragraph (6) and redesignating paragraphs (7) and
9 (8) as paragraphs (6) and (7), respectively.

10 (2) Subsection (b) of section 1504 (defining in-
11 cludible corporation) is amended by adding at the
12 end the following new paragraph:

13 “(8) An S corporation.”

14 **SEC. 222. C CORPORATION RULES TO APPLY FOR FRINGE**
15 **BENEFIT PURPOSES.**

16 (a) IN GENERAL.—Section 1372 (relating to partner-
17 ship rules to apply for fringe benefit purposes) is repealed.

18 (b) CONFORMING AMENDMENTS.—

19 (1) Section 162(l) is amended by striking para-
20 graph (5) and by redesignating paragraph (6) as
21 paragraph (5).

22 (2) The table of sections for part III of sub-
23 chapter S of chapter 1 is amended by striking the
24 item relating to section 1372.

1 **SEC. 223. TREATMENT OF DISTRIBUTIONS DURING LOSS**
2 **YEARS.**

3 (a) ADJUSTMENTS FOR DISTRIBUTIONS TAKEN INTO
4 ACCOUNT BEFORE LOSSES.—

5 (1) Subparagraph (A) of section 1366(d)(1)
6 (relating to losses and deductions cannot exceed
7 shareholder's basis in stock and debt) is amended by
8 striking "paragraph (1)" and inserting "paragraphs
9 (1) and (2)(A)".

10 (2) Subsection (d) of section 1368 (relating to
11 certain adjustments taken into account) is amended
12 by adding at the end the following new sentence:

13 "In the case of any distribution made during any taxable
14 year, the adjusted basis of the stock shall be determined
15 with regard to the adjustments provided in paragraph (1)
16 of section 1367(a) for the taxable year."

17 (b) ACCUMULATED ADJUSTMENTS ACCOUNT.—Para-
18 graph (1) of section 1368(e) (relating to accumulated ad-
19 justments account) is amended by adding at the end the
20 following new subparagraph:

21 "(C) NET LOSS FOR YEAR DISREGARDED.—

22 "(i) IN GENERAL.—In applying this section
23 to distributions made during any taxable year,
24 the amount in the accumulated adjustments ac-
25 count as of the close of such taxable year shall

1 be determined without regard to any net nega-
 2 tive adjustment for such taxable year.

3 “(ii) NET NEGATIVE ADJUSTMENT.—For
 4 purposes of clause (i), the term ‘net negative
 5 adjustment’ means, with respect to any taxable
 6 year, the excess (if any) of—

7 “(I) the reductions in the account for
 8 the taxable year (other than for distribu-
 9 tions), over

10 “(II) the increases in such account for
 11 such taxable year.”

12 (c) CONFORMING AMENDMENTS.—Subparagraph (A)
 13 of section 1368(e)(1) is amended—

14 (1) by striking “as provided in subparagraph
 15 (B)” and inserting “as otherwise provided in this
 16 paragraph”, and

17 (2) by striking “section 1367(b)(2)(A)” and in-
 18 serting “section 1367(a)(2)”.

19 **SEC. 224. CONSENT DIVIDEND FOR AAA BYPASS ELECTION.**

20 Section 1368(e)(3) (relating to election to distribute
 21 earnings first) is amended by adding at the end the follow-
 22 ing new subparagraph:

23 “(C) CONSENT DIVIDEND.—Under regula-
 24 tions prescribed by the Secretary, an S corpora-
 25 tion may, subject to the election under this

1 paragraph, consent to treat as a distribution
2 the amount specified in such consent, to the ex-
3 tent such amount does not exceed the accumu-
4 lated earnings and profits of such corporation.
5 The amount so specified shall be considered—

6 “(i) as distributed in money by the
7 corporation to its shareholders on the last
8 day of the taxable year of the corporation
9 and as contributed to the capital of the
10 corporation by the shareholders on such
11 day, and

12 “(ii) if any such shareholder is an or-
13 ganization described in section 511(a)(2),
14 as unrelated business taxable income (as
15 defined in section 512) to such share-
16 holder.”

17 **SEC. 225. TREATMENT OF S CORPORATIONS UNDER SUB-**
18 **CHAPTER C.**

19 Subsection (a) of section 1371 (relating to applica-
20 tion of subchapter C rules) is amended to read as follows:

21 “(a) APPLICATION OF SUBCHAPTER C RULES.—Ex-
22 cept as otherwise provided in this title, and except to the
23 extent inconsistent with this subchapter, subchapter C
24 shall apply to an S corporation and its shareholders.”

1 **SEC. 226. ELIMINATION OF PRE-1983 EARNINGS AND**
2 **PROFITS.**

3 (a) IN GENERAL.—If—

4 (1) a corporation was an electing small business
5 corporation under subchapter S of chapter 1 of the
6 Internal Revenue Code of 1986 for any taxable year
7 beginning before January 1, 1983, and

8 (2) such corporation is an S corporation under
9 subchapter S of chapter 1 of such Code for its first
10 taxable year beginning after December 31, 1993,
11 the amount of such corporation's accumulated earnings
12 and profits (as of the beginning of such first taxable year)
13 shall be reduced by an amount equal to the portion (if
14 any) of such accumulated earnings and profits which were
15 accumulated in any taxable year beginning before January
16 1, 1983, for which such corporation was an electing small
17 business corporation under such subchapter S.

18 (b) CONFORMING AMENDMENTS.—

19 (1)(A) Subsection (a) of section 1375 is amend-
20 ed by striking “subchapter C” in paragraph (1) and
21 inserting “accumulated”.

22 (B) Subsection (b) of section 1375, as amended
23 by section 214(c)(2), is amended by striking para-
24 graph (3) and by redesignating paragraphs (4) and
25 (5) as paragraphs (3) and (4), respectively.

1 (C) The section heading for section 1375 is
 2 amended by striking “**SUBCHAPTER C**” and insert-
 3 ing “**ACCUMULATED**”.

4 (D) The table of sections for part III of sub-
 5 chapter S of chapter 1 is amended by striking “sub-
 6 chapter C” in the item relating to section 1375 and
 7 inserting “accumulated”.

8 (2) Clause (i) of section 1042(c)(4)(A), as
 9 amended by section 214(c)(5), is amended by strik-
 10 ing “section 1375(b)(5)” and inserting “section
 11 1375(b)(4)”.

12 **SEC. 227. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**
 13 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

14 (a) **IN GENERAL.**—Section 170(e) (relating to certain
 15 contributions of ordinary income and capital gain prop-
 16 erty) is amended—

17 (1) by striking “(other than a corporation
 18 which is an S corporation)” in paragraph (3)(A),
 19 and

20 (2) by striking clause (i) of paragraph (4)(D)
 21 and by redesignating clauses (ii) and (iii) of such
 22 paragraph as clauses (i) and (ii), respectively.

23 (b) **STOCK BASIS ADJUSTMENT.**—Paragraph (1) of
 24 section 1367(a) (relating to adjustments to basis of stock
 25 of shareholders, etc.) is amended by striking “and” at the

1 end of subparagraph (B), by striking the period at the
 2 end of subparagraph (C) and inserting “, and”, and by
 3 adding at the end the following new subparagraph:

4 “(D) the excess of the deductions for char-
 5 itable contributions over the basis of the prop-
 6 erty contributed.”

7 **TITLE III—TAXATION OF S** 8 **CORPORATION SHAREHOLDERS**

9 **SEC. 301. UNIFORM TREATMENT OF OWNER-EMPLOYEES** 10 **UNDER PROHIBITED TRANSACTION RULES.**

11 The last sentence of section 4975(d) (relating to ex-
 12 emptions from prohibited transactions) is amended by
 13 striking “a shareholder-employee (as defined in section
 14 1379, as in effect on the day before the date of the enact-
 15 ment of the Subchapter S Revision Act of 1982),”.

16 **SEC. 302. TREATMENT OF LOSSES TO SHAREHOLDERS.**

17 (a) TREATMENT OF LOSSES IN LIQUIDATIONS.—Sec-
 18 tion 331 (relating to gain or loss to shareholders in cor-
 19 porate liquidations) is amended by redesignating sub-
 20 section (c) as subsection (d) and by inserting after sub-
 21 section (b) the following new subsection:

22 “(c) LOSSES ON LIQUIDATIONS OF S CORPORA-
 23 TION.—

24 “(1) IN GENERAL.—The portion of any loss rec-
 25 ognized by a shareholder of an S corporation (as de-

1 fined in section 1361(a)(1)) on amounts received by
2 such shareholder in a distribution in complete liq-
3 uidation of such S corporation which does not exceed
4 the ordinary income basis of stock of such S cor-
5 poration in the hands of such shareholder shall not
6 be treated as a loss from the sale or exchange of a
7 capital asset but shall be treated as an ordinary loss.

8 “(2) ORDINARY INCOME BASIS.—For purposes
9 of this subsection, the ordinary income basis of stock
10 of an S corporation in the hands of a shareholder of
11 such S corporation shall be an amount equal to the
12 portion of such shareholder’s basis in such stock
13 which is equal to the aggregate increases in such
14 basis under section 1367(a)(1) resulting from such
15 shareholder’s pro rata share of ordinary income of
16 such S corporation attributable to the complete
17 liquidation.”

18 (b) CARRYOVER OF DISALLOWED LOSSES AND DE-
19 DUCTIONS UNDER AT-RISK RULES ALLOWED.—Para-
20 graph (3) of section 1366(d) (relating to carryover of dis-
21 allowed losses and deductions to post-termination transi-
22 tion period) is amended by adding at the end the following
23 new subparagraph:

24 “(D) AT-RISK LIMITATIONS.—To the ex-
25 tent that any increase in adjusted basis de-

1 scribed in subparagraph (B) would have in-
2 creased the shareholder's amount at risk under
3 section 465 if such increase had occurred on
4 the day preceding the commencement of the
5 post-termination transition period, rules similar
6 to the rules described in subparagraphs (A)
7 through (C) shall apply to any losses disallowed
8 by reason of section 465(a).''

9 **TITLE IV—EFFECTIVE DATE**

10 **SEC. 401. EFFECTIVE DATE.**

11 Except as otherwise provided in this Act, the amend-
12 ments made by this Act shall apply to taxable years begin-
13 ning after December 31, 1994.

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