

103D CONGRESS  
1ST SESSION

# S. 1690

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

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## IN THE SENATE OF THE UNITED STATES

NOVEMBER 19 (legislative day, NOVEMBER 2), 1993

Mr. PRYOR (for himself, Mr. DANFORTH, Mr. BOREN, Mr. HATCH, Mr. CONRAD, Mr. WALLOP, Mr. SASSER, Mr. HATFIELD, and Mr. MATHEWS) introduced the following bill; which was read twice and referred to the Committee on Finance

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## 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 “S  
6 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

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

4 (c) TABLE OF CONTENTS.—The table of contents of  
 5 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

1           “(ii) in the case of a family with re-  
2           spect to which an election is in effect  
3           under subparagraph (E), all members of  
4           the family shall be treated as 1 share-  
5           holder.

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

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

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

24          “(E) ELECTION.—An election under sub-  
25          paragraph (A)(ii)—

1 “(i) must be made with the consent of  
2 all shareholders,

3 “(ii) shall remain in effect until termi-  
4 nated, and

5 “(iii) shall apply only with respect to  
6 1 family in any corporation.”

7 **Subtitle B—Persons Allowed as**  
8 **Shareholders**

9 **SEC. 111. CERTAIN EXEMPT ORGANIZATIONS.**

10 (a) CERTAIN EXEMPT ORGANIZATIONS ALLOWED TO  
11 BE SHAREHOLDERS.—

12 (1) IN GENERAL.—Subparagraph (B) of section  
13 1361(b)(1) (defining small business corporation) is  
14 amended to read as follows:

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

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

23 “(7) CERTAIN EXEMPT ORGANIZATIONS PER-  
24 Mitted AS SHAREHOLDERS.—For purposes of sub-  
25 section (b)(1)(B), an organization described in sec-

1       tion 401(a) or 501(c)(3) may be a shareholder in an  
2       S corporation.”

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

12      (c) SPECIAL RULES APPLICABLE TO PARTNERSHIPS  
13      AND S CORPORATIONS.—

14           (1) IN GENERAL.—Subsection (c) of section  
15      512 (relating to unrelated business tax income) is  
16      amended—

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

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

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

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

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

15 **SEC. 112. FINANCIAL INSTITUTIONS.**

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

18                       “(B) a financial institution which uses the  
19                       reserve method of accounting for bad debts de-  
20                       scribed in section 585 or 593.”.

21 **SEC. 113. NONRESIDENT ALIENS.**

22           (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-  
23 HOLDERS.—

1 (1) IN GENERAL.—Paragraph (1) of section  
2 1361(b) (defining small business corporation) is  
3 amended—

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

6 (B) by striking subparagraph (C), and

7 (C) by redesignating subparagraph (D) as  
8 subparagraph (C).

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

14 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED  
15 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED  
16 STATES.—

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

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

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

22 (C) by adding at the end the following new  
23 paragraph:

24 “(3) a nonresident alien individual shall be con-  
25 sidered as being engaged in a trade or business



1 within the United States if the S corporation of  
 2 which such individual is a shareholder is so en-  
 3 gaged.”

4 (2) APPLICATION OF WITHHOLDING TAX ON  
 5 NONRESIDENT ALIEN SHAREHOLDERS.—Section  
 6 1446 (relating to withholding tax on foreign part-  
 7 ners’ share of effectively connected income) is  
 8 amended by redesignating subsection (f) as sub-  
 9 section (g) and by inserting after subsection (e) the  
 10 following new subsection:

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

13 “(1) an S corporation shall be treated as a  
 14 partnership,

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

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

19 (3) CONFORMING AMENDMENTS.—

20 (A) The heading of section 875 is amended  
 21 to read as follows:

22 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**  
 23 **AND TRUSTS; S CORPORATIONS.”**

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

1 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**  
 2 **AND S CORPORATE SHAREHOLDERS’ SHARE**  
 3 **OF EFFECTIVELY CONNECTED INCOME.”**

4 (4) CLERICAL AMENDMENTS.—

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

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

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

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

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

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

1 such S corporation, shall be treated as having a permanent  
2 establishment in the United States for purposes of such  
3 treaty.”

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

5 (a) GENERAL RULE.—Subparagraph (A) of section  
6 1361(c)(2) (relating to certain trusts permitted as share-  
7 holders) is amended by inserting after clause (iv) the fol-  
8 lowing new clause:

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

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

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

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

24 “(e) ELECTING SMALL BUSINESS TRUST DE-  
25 FINED.—

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

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

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

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

12           “(iii) an election under this subsection  
13 applies to such trust.

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

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

22           “(ii) any trust exempt from tax under  
23 this subtitle.

24           “(C) PURCHASE.—For purposes of sub-  
25 paragraph (A), the term ‘purchase’ means any

1           acquisition if the basis of the property acquired  
2           is determined under section 1012.

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

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

1 “(4) CROSS REFERENCE.—

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

2 (d) TAXATION OF ELECTING SMALL BUSINESS  
3 TRUSTS.—Section 641 (relating to imposition of tax on  
4 trusts) is amended by adding at the end the following new  
5 subsection:

6 “(d) SPECIAL RULES FOR TAXATION OF ELECTING  
7 SMALL BUSINESS TRUSTS.—

8 “(1) IN GENERAL.—For purposes of this chap-  
9 ter—

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

14 “(B) the amount of the tax imposed by  
15 this chapter on such separate trust shall be de-  
16 termined with the modifications of paragraph  
17 (2).

18 “(2) MODIFICATIONS.—For purposes of para-  
19 graph (1), the modifications of this paragraph are  
20 the following:

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

1           “(B) The exemption amount under section  
2           55(d) shall be zero.

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

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

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

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

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

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

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

24                   “(A) the amount of the tax imposed by  
25                   this chapter on the portion of any electing small

1 business trust not treated as a separate trust  
2 under paragraph (1), and

3 “(B) the distributable net income of the  
4 entire trust,

5 the items referred to in paragraph (2)(C) shall be  
6 excluded. Except as provided in the preceding sen-  
7 tence, this subsection shall not affect the taxation of  
8 any distribution from the trust.

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

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

## 20 **Subtitle C—Other Provisions**

### 21 **SEC. 121. EXPANSION OF POST-DEATH QUALIFICATION FOR** 22 **CERTAIN TRUSTS.**

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



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

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

5 **TITLE II—QUALIFICATION AND**  
 6 **ELIGIBILITY REQUIREMENTS**  
 7 **FOR S CORPORATIONS**

8 **Subtitle A—One Class of Stock**

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

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

13 “(8) TREATMENT OF QUALIFIED PREFERRED  
 14 STOCK.—

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

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

24 “(C) DISTRIBUTIONS.—A distribution (not  
 25 in part or full payment in exchange for stock)

1           made by the corporation with respect to quali-  
2           fied preferred stock shall be includible as inter-  
3           est income of the holder and deductible to the  
4           corporation as interest expense in computing  
5           taxable income under section 1363(b) in the  
6           year such distribution is received.”

7           (b) CONFORMING AMENDMENTS.—

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

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

14          “(3) ALLOCATION WITH RESPECT TO QUALI-  
15          FIED PREFERRED STOCK.—The holders of qualified  
16          preferred stock shall not, with respect to such stock,  
17          be allocated any of the items described in paragraph  
18          (1).”

19   **SEC. 202. FINANCIAL INSTITUTIONS PERMITTED TO HOLD**  
20                   **SAFE HARBOR DEBT.**

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

1           “(ii) in any case in which the terms of  
2           such promise include a provision under  
3           which the obligation to pay may be con-  
4           verted (directly or indirectly) into stock of  
5           the corporation, such terms, taken as a  
6           whole, are substantially the same as the  
7           terms which could have been obtained on  
8           the effective date of the promise from a  
9           person which is not a related person (with-  
10          in the meaning of section 465(b)(3)(C)) to  
11          the S corporation or its shareholders, and  
12          “(iii) the creditor is—  
13                  “(I) an individual,  
14                  “(II) an estate,  
15                  “(III) a trust described in para-  
16          graph (2), or  
17                  “(IV) a person which is actively  
18          and regularly engaged in the business  
19          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) an election under subsection (a) by any corporation—

“(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

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

“(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

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

1           “(A) so that the corporation is a small  
2           business corporation, or

3           “(B) to acquire the required shareholder  
4           consents, and

5           “(4) the corporation, and each person who was  
6           a shareholder in the corporation at any time during  
7           the period specified pursuant to this subsection,  
8           agrees to make such adjustments (consistent with  
9           the treatment of the corporation as an S corpora-  
10          tion) as may be required by the Secretary with re-  
11          spect to such period,

12          then, notwithstanding the circumstances resulting in such  
13          ineffectiveness or termination, such corporation shall be  
14          treated as an S corporation during the period specified  
15          by the Secretary.”

16          (b) LATE ELECTIONS.—Subsection (b) of section  
17          1362 is amended by adding at the end thereof the follow-  
18          ing new paragraph:

19                 “(5) AUTHORITY TO TREAT LATE ELECTIONS  
20                 AS TIMELY.—If—

21                 “(A) an election under subsection (a) is  
22                 made for any taxable year (determined without  
23                 regard to paragraph (3)) after the date pre-  
24                 scribed by this subsection for making such elec-  
25                 tion for such taxable year, and

1           “(B) the Secretary determines that there  
2           was reasonable cause for the failure to timely  
3           make such election,  
4           the Secretary may treat such election as timely  
5           made for such taxable year (and paragraph (3) shall  
6           not apply).”

7           (c) AUTOMATIC WAIVERS.—The Secretary of the  
8           Treasury shall provide for an automatic waiver procedure  
9           under section 1362(f) of the Internal Revenue Code of  
10          1986 in cases in which the Secretary determines appro-  
11          priate.

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

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

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

18               “(2) ELECTION TO TERMINATE YEAR.—

19                       “(A) IN GENERAL.—Under regulations  
20                       prescribed by the Secretary, if any shareholder  
21                       terminates the shareholder’s interest in the cor-  
22                       poration during the taxable year and all af-  
23                       fected shareholders agree to the application of  
24                       this paragraph, paragraph (1) shall be applied  
25                       to the affected shareholders as if the taxable

1           year consisted of 2 taxable years the first of  
2           which ends on the date of the termination.

3           “(B) AFFECTED SHAREHOLDERS.—For  
4           purposes of subparagraph (A), the term ‘af-  
5           fected shareholders’ means the shareholder  
6           whose interest is terminated and all sharehold-  
7           ers to whom such shareholder has transferred  
8           shares during the taxable year. If such share-  
9           holder has transferred shares to the corpora-  
10          tion, the term ‘affected shareholders’ shall in-  
11          clude all persons who are shareholders during  
12          the taxable year.”

13 **SEC. 213. EXPANSION OF POST-TERMINATION TRANSITION**  
14 **PERIOD.**

15          (a) IN GENERAL.—Paragraph (1) of section 1377(b)  
16 (relating to post-termination transition period) is amended  
17 by striking “and” at the end of subparagraph (A), by re-  
18 designating subparagraph (B) as subparagraph (C), and  
19 by inserting after subparagraph (A) the following new sub-  
20 paragraph:

21           “(B) the 120-day period beginning on the  
22           date of any determination pursuant to an audit  
23           of the taxpayer which follows the termination of  
24           the corporation’s election and which adjusts a  
25           subchapter S item of income, loss, or deduction

1 of the corporation arising during the S period  
2 (as defined in section 1368(e)(2)), and”.

3 (b) DETERMINATION DEFINED.—Paragraph (2) of  
4 section 1377(b) is amended by striking subparagraphs (A)  
5 and (B), by redesignating subparagraph (C) as subpara-  
6 graph (B), and by inserting before subparagraph (B) (as  
7 so redesignated) the following new subparagraph:

8 “(A) a determination as defined in section  
9 1313(a), or”.

10 (c) REPEAL OF SPECIAL AUDIT PROVISIONS FOR  
11 SUBCHAPTER S ITEMS.—

12 (1) GENERAL RULE.—Subchapter D of chapter  
13 63 (relating to tax treatment of subchapter S items)  
14 is hereby repealed.

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

19 “(d) SHAREHOLDER’S RETURN MUST BE CONSIST-  
20 ENT WITH CORPORATE RETURN OR SECRETARY NOTI-  
21 FIED OF INCONSISTENCY.—

22 “(1) IN GENERAL.—A shareholder of an S cor-  
23 poration shall, on such shareholder’s return, treat a  
24 subchapter S item in a manner which is consistent



1 with the treatment of such item on the corporate  
2 return.

3 “(2) NOTIFICATION OF INCONSISTENT TREAT-  
4 MENT.—

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

7 “(i)(I) the corporation has filed a re-  
8 turn but the shareholder’s treatment on  
9 his return is (or may be) inconsistent with  
10 the treatment of the item on the corporate  
11 return, or

12 “(II) the corporation has not filed a  
13 return, and

14 “(ii) the shareholder files with the  
15 Secretary a statement identifying the in-  
16 consistency,

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

18 “(B) SHAREHOLDER RECEIVING INCOR-  
19 RECT INFORMATION.—A shareholder shall be  
20 treated as having complied with clause (ii) of  
21 subparagraph (A) with respect to a subchapter  
22 S item if the shareholder—

23 “(i) demonstrates to the satisfaction  
24 of the Secretary that the treatment of the  
25 subchapter S item on the shareholder’s re-

1                   turn is consistent with the treatment of the  
 2                   item on the schedule furnished to the  
 3                   shareholder by the corporation, and

4                   “(ii) elects to have this paragraph  
 5                   apply with respect to that item.

6                   “(3) EFFECT OF FAILURE TO NOTIFY.—In any  
 7                   case—

8                   “(A) described in subparagraph (A)(i)(I)  
 9                   of paragraph (2), and

10                  “(B) in which the shareholder does not  
 11                  comply with subparagraph (A)(ii) of paragraph  
 12                  (2),

13                  any adjustment required to make the treatment of  
 14                  the items by such shareholder consistent with the  
 15                  treatment of the items on the corporate return shall  
 16                  be treated as arising out of mathematical or clerical  
 17                  errors and assessed according to section 6213(b)(1).  
 18                  Paragraph (2) of section 6213(b) shall not apply to  
 19                  any assessment referred to in the preceding sen-  
 20                  tence.

21                  “(4) SUBCHAPTER S ITEM.—For purposes of  
 22                  this subsection, the term ‘subchapter S item’ means  
 23                  any item of an S corporation to the extent that reg-  
 24                  ulations prescribed by the Secretary provide that, for  
 25                  purposes of this subtitle, such item is more appro-

1 priately determined at the corporation level than at  
 2 the shareholder level.

3 “(5) ADDITION TO TAX FOR FAILURE TO COM-  
 4 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.”

5 (3) CONFORMING AMENDMENTS.—

6 (A) Section 1366 is amended by striking  
 7 subsection (g).

8 (B) Subsection (b) of section 6233 is  
 9 amended to read as follows:

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

15 (C) The table of subchapters for chapter  
 16 63 is amended by striking the item relating to  
 17 subchapter D.

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

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

22 (b) MODIFICATION OF TAX IMPOSED ON EXCESSIVE  
 23 PASSIVE INVESTMENT INCOME.—

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

8 (2) TAX RATE INCREASE AFTER THIRD CON-  
 9 SECUTIVE YEAR.—Section 1375 is amended by re-  
 10 designating subsections (c) and (d) as subsections  
 11 (d) and (e), respectively, and by inserting after sub-  
 12 section (b) the following new subsection:

13 “(c) TAX RATE INCREASE AFTER THIRD CONSECU-  
 14 TIVE YEAR.—

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

“In the case of the—

**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:**

4th taxable year .....	10
5th taxable year .....	20
6th taxable year .....	30
7th taxable year .....	40
8th taxable year and thereafter .....	50.

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

4       (c) CONFORMING AMENDMENTS.—

5           (1) Section 1362(f)(1) is amended by striking  
6       “or (3)”.

7           (2) Subsection (b) of section 1375 is amended  
8       by striking paragraphs (3) and (4) and inserting the  
9       following new paragraphs:

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

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

22          “(5) PASSIVE INVESTMENT INCOME DE-  
23       FINED.—

24               “(A) IN GENERAL.—Except as otherwise  
25       provided in this paragraph, the term ‘passive

1 investment income’ means gross receipts de-  
2 rived from royalties, rents, dividends, interest,  
3 and annuities.

4 “(B) EXCEPTION FOR INTEREST ON  
5 NOTES FROM SALES OF INVENTORY.—The term  
6 ‘passive investment income’ shall not include in-  
7 terest on any obligation acquired in the ordi-  
8 nary course of the corporation’s trade or busi-  
9 ness from its sale of property described in sec-  
10 tion 1221(1).

11 “(C) TREATMENT OF CERTAIN LENDING  
12 OR FINANCE COMPANIES.—If the S corporation  
13 meets the requirements of section 542(c)(6) for  
14 the taxable year, the term ‘passive investment  
15 income’ shall not include gross receipts for the  
16 taxable year which are derived directly from the  
17 active and regular conduct of a lending or fi-  
18 nance business (as defined in section  
19 542(d)(1)).

20 “(D) SPECIAL RULE FOR OPTIONS AND  
21 COMMODITY DEALINGS.—

22 “(i) IN GENERAL.—In the case of any  
23 options dealer or commodities dealer, pas-  
24 sive investment income shall be determined  
25 by not taking into account any gain or loss

(in the normal course of the taxpayer' activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to such a contract.

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

“(I) OPTIONS DEALER.—The term ‘options dealer’ has the meaning given such term by section 1256(g)(8).

“(II) COMMODITIES DEALER.—The term ‘commodities dealer’ means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

“(III) SECTION 1256 CONTRACT.—The term ‘section 1256 contract’ has the meaning given to such term by section 1256(b).

“(E) COORDINATION WITH SECTION 1374.—The amount of passive investment income shall be determined by not taking into ac-

1 count any recognized built-in gain or loss of the  
 2 S corporation for any taxable year in the rec-  
 3 ognition period. Terms used in the preceding  
 4 sentence shall have the same respective mean-  
 5 ing as when used in section 1374.”

6 (3) The heading for section 1375 is amended by  
 7 striking “**25**” and inserting “**50**”.

8 (4) The table of sections for part III of sub-  
 9 chapter S of chapter 1 is amended by striking “25”  
 10 in the item relating to section 1375 and inserting  
 11 “50”.

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

## 15 **Subtitle C—Other Provisions**

### 16 **SEC. 221. S CORPORATIONS PERMITTED TO HOLD SUBSIDI-** 17 **ARIES.**

18 (a) IN GENERAL.—Paragraph (2) of section 1361(b)  
 19 (defining ineligible corporation) is amended by striking  
 20 subparagraph (A) and by redesignating subparagraphs  
 21 (B), (C), (D), and (E) as subparagraphs (A), (B), (C),  
 22 and (D), respectively.

23 (b) CERTAIN DIVIDENDS NOT TREATED AS PASSIVE  
 24 INVESTMENT INCOME.—Section 1375(b)(5) (defining pas-  
 25 sive investment income), as added by section 214(c)(2),



1 is amended by adding at the end the following new sub-  
2 paragraph:

3           “(F) TREATMENT OF CERTAIN DIVI-  
4           DENDS.—If an S corporation holds stock in a  
5           C corporation meeting the requirements of sec-  
6           tion 1504(a)(2), the term ‘passive investment  
7           income’ shall not include dividends from such C  
8           corporation to the extent such dividends are at-  
9           tributable to the earnings and profits of such C  
10          corporation derived from the active conduct of  
11          a trade or business.”

12       (c) CONFORMING AMENDMENTS.—

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

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

20           “(8) An S corporation.”

21       **SEC. 222. C CORPORATION RULES TO APPLY FOR FRINGE**  
22               **BENEFIT PURPOSES.**

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

25           (b) CONFORMING AMENDMENTS.—

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

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

7 **SEC. 223. TREATMENT OF DISTRIBUTIONS DURING LOSS**  
 8 **YEARS.**

9 (a) ADJUSTMENTS FOR DISTRIBUTIONS TAKEN INTO  
 10 ACCOUNT BEFORE LOSSES.—

11 (1) Subparagraph (A) of section 1366(d)(1)  
 12 (relating to losses and deductions cannot exceed  
 13 shareholder's basis in stock and debt) is amended by  
 14 striking “paragraph (1)” and inserting “paragraphs  
 15 (1) and (2)(A)”.

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

19 “In the case of any distribution made during any taxable  
 20 year, the adjusted basis of the stock shall be determined  
 21 with regard to the adjustments provided in paragraph (1)  
 22 of section 1367(a) for the taxable year.”

23 (b) ACCUMULATED ADJUSTMENTS ACCOUNT.—Para-  
 24 graph (1) of section 1368(e) (relating to accumulated ad-

1 justments account) is amended by adding at the end the  
 2 following new subparagraph:

3 “(C) NET LOSS FOR YEAR DISREGARDED.—

4 “(i) IN GENERAL.—In applying this section  
 5 to distributions made during any taxable year,  
 6 the amount in the accumulated adjustments ac-  
 7 count as of the close of such taxable year shall  
 8 be determined without regard to any net nega-  
 9 tive adjustment for such taxable year.

10 “(ii) NET NEGATIVE ADJUSTMENT.—For  
 11 purposes of clause (i), the term ‘net negative  
 12 adjustment’ means, with respect to any taxable  
 13 year, the excess (if any) of—

14 “(I) the reductions in the account for  
 15 the taxable year (other than for distribu-  
 16 tions), over

17 “(II) the increases in such account for  
 18 such taxable year.”

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

21 (1) by striking “as provided in subparagraph  
 22 (B)” and inserting “as otherwise provided in this  
 23 paragraph”, and

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

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

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

5 “(C) CONSENT DIVIDEND.—Under regula-  
6 tions prescribed by the Secretary, an S corpora-  
7 tion may, subject to the election under this  
8 paragraph, consent to treat as a distribution  
9 the amount specified in such consent, to the ex-  
10 tent such amount does not exceed the accumu-  
11 lated earnings and profits of such corporation.  
12 The amount so specified shall be considered—

13 “(i) as distributed in money by the  
14 corporation to its shareholders on the last  
15 day of the taxable year of the corporation  
16 and as contributed to the capital of the  
17 corporation by the shareholders on such  
18 day, and

19 “(ii) if any such shareholder is an or-  
20 ganization described in section 511(a)(2),  
21 as unrelated business taxable income (as  
22 defined in section 512) to such share-  
23 holder.”

1 **SEC. 225. TREATMENT OF S CORPORATIONS UNDER SUB-**  
2 **CHAPTER C.**

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

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

9 **SEC. 226. ELIMINATION OF PRE-1983 EARNINGS AND**  
10 **PROFITS.**

11 (a) IN GENERAL.—If—

12 (1) a corporation was an electing small business  
13 corporation under subchapter S of chapter 1 of the  
14 Internal Revenue Code of 1986 for any taxable year  
15 beginning before January 1, 1983, and

16 (2) such corporation is an S corporation under  
17 subchapter S of chapter 1 of such Code for its first  
18 taxable year beginning after December 31, 1993,  
19 the amount of such corporation’s accumulated earnings  
20 and profits (as of the beginning of such first taxable year)  
21 shall be reduced by an amount equal to the portion (if  
22 any) of such accumulated earnings and profits which were  
23 accumulated in any taxable year beginning before January  
24 1, 1983, for which such corporation was an electing small  
25 business corporation under such subchapter S.

26 (b) CONFORMING AMENDMENTS.—

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

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

8           (C) The section heading for section 1375 is  
 9           amended by striking “**SUBCHAPTER C**” and insert-  
 10          ing “**ACCUMULATED**”.

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

15          (2) Clause (i) of section 1042(c)(4)(A), as  
 16          amended by section 214(c)(5), is amended by strik-  
 17          ing “section 1375(b)(5)” and inserting “section  
 18          1375(b)(4)”.

19 **SEC. 227. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**  
 20 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

21          (a) IN GENERAL.—Section 170(e) (relating to certain  
 22          contributions of ordinary income and capital gain prop-  
 23          erty) is amended—

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

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

7       (b) STOCK BASIS ADJUSTMENT.—Paragraph (1) of  
8       section 1367(a) (relating to adjustments to basis of stock  
9       of shareholders, etc.) is amended by striking “and” at the  
10      end of subparagraph (B), by striking the period at the  
11      end of subparagraph (C) and inserting “, and”, and by  
12      adding at the end the following new subparagraph:

13                   “(D) the excess of the deductions for char-  
14                   itable contributions over the basis of the prop-  
15                   erty contributed.”

## 16                   **TITLE III—TAXATION OF S** 17                   **CORPORATION SHAREHOLDERS**

### 18                   **SEC. 301. UNIFORM TREATMENT OF OWNER-EMPLOYEES**

#### 19                                   **UNDER PROHIBITED TRANSACTION RULES.**

20       The last sentence of section 4975(d) (relating to ex-  
21      emptions from prohibited transactions) is amended by  
22      striking “a shareholder-employee (as defined in section  
23      1379, as in effect on the day before the date of the enact-  
24      ment of the Subchapter S Revision Act of 1982),”.

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

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

7 “(c) LOSSES ON LIQUIDATIONS OF S CORPORA-  
8 TION.—

9 “(1) IN GENERAL.—The portion of any loss rec-  
10 ognized by a shareholder of an S corporation (as de-  
11 fined in section 1361(a)(1)) on amounts received by  
12 such shareholder in a distribution in complete liq-  
13 uidation of such S corporation which does not exceed  
14 the ordinary income basis of stock of such S cor-  
15 poration in the hands of such shareholder shall not  
16 be treated as a loss from the sale or exchange of a  
17 capital asset but shall be treated as an ordinary loss.

18 “(2) ORDINARY INCOME BASIS.—For purposes  
19 of this subsection, the ordinary income basis of stock  
20 of an S corporation in the hands of a shareholder of  
21 such S corporation shall be an amount equal to the  
22 portion of such shareholder’s basis in such stock  
23 which is equal to the aggregate increases in such  
24 basis under section 1367(a)(1) resulting from such  
25 shareholder’s pro rata share of ordinary income of



1       such S corporation attributable to the complete  
2       liquidation.”

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

9               “(D) AT-RISK LIMITATIONS.—To the ex-  
10              tent that any increase in adjusted basis de-  
11              scribed in subparagraph (B) would have in-  
12              creased the shareholder’s amount at risk under  
13              section 465 if such increase had occurred on  
14              the day preceding the commencement of the  
15              post-termination transition period, rules similar  
16              to the rules described in subparagraphs (A)  
17              through (C) shall apply to any losses disallowed  
18              by reason of section 465(a).”

## 19       **TITLE IV—EFFECTIVE DATE**

### 20       **SEC. 401. EFFECTIVE DATE.**

21       Except as otherwise provided in this Act, the amend-  
22       ments made by this Act shall apply to taxable years begin-  
23       ning after December 31, 1993.

○

S 1690 IS——2

S 1690 IS——3

S 1690 IS——4