

109TH CONGRESS
1ST SESSION

H. R. 4421

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 18, 2005

Mr. SHAW (for himself and Mr. RAMSTAD) 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 provide for S corporation reform, and for other purposes.

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, REFERENCE.**

4 (a) SHORT TITLE.—This Act may be cited as the “S
5 Corporation Reform Act of 2005”.

6 (b) AMENDMENT OF 1986 CODE.—Except as other-
7 wise expressly provided, whenever in this Act an amend-
8 ment or repeal is expressed in terms of an amendment
9 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 **SEC. 2. REDUCED RECOGNITION PERIOD FOR BUILT-IN**
4 **GAINS.**

5 (a) IN GENERAL.—Paragraph (7) of section 1374(d)
6 (relating to definitions and special rules) is amended by
7 striking “10-year” both places it appears and inserting
8 “7-year”.

9 (b) APPLICATION TO REGULATED INVESTMENT COM-
10 PANIES AND REAL ESTATE INVESTMENT TRUSTS.—For
11 purposes of paragraph (1) of section 337(d) and the regu-
12 lations thereunder, any reference to the 10-year recogni-
13 tion period under section 1374 shall be applied as if the
14 reference were to a 7-year recognition period.

15 (c) EFFECTIVE DATE.—

16 (1) GENERAL RULE.—The amendment made by
17 this section shall apply to any recognition period in
18 effect on or after the date of the enactment of this
19 Act.

20 (2) SPECIAL APPLICATION TO EXISTING PERI-
21 ODS EXCEEDING 7 YEARS.—Any recognition period
22 (as defined in section 1374(d)(7) of the Internal
23 Revenue Code of 1986) which is in effect on the
24 date of the enactment of this Act and which is in
25 the 8th, 9th, or 10th year after the beginning of

1 such period shall end on the date of the enactment
2 of this Act.

3 **SEC. 3. ISSUANCE OF PREFERRED STOCK PERMITTED.**

4 (a) IN GENERAL.—Section 1361 (defining S corpora-
5 tion) is amended by adding at the end the following new
6 subsection:

7 “(f) TREATMENT OF QUALIFIED PREFERRED
8 STOCK.—

9 “(1) IN GENERAL.—For purposes of this sub-
10 chapter—

11 “(A) qualified preferred stock shall not be
12 treated as a second class of stock, and

13 “(B) no person shall be treated as a share-
14 holder of the corporation by reason of holding
15 qualified preferred stock.

16 “(2) QUALIFIED PREFERRED STOCK DE-
17 FINED.—For purposes of this subsection, the term
18 ‘qualified preferred stock’ means stock which meets
19 the requirements of subparagraphs (A), (B), and (C)
20 of section 1504(a)(4). Stock shall not fail to be
21 treated as qualified preferred stock merely because
22 it is convertible into other stock.

23 “(3) DISTRIBUTIONS.—A distribution (not in
24 part or full payment in exchange for stock) made by
25 the corporation with respect to qualified preferred

1 stock shall be includible as ordinary income of the
2 holder and deductible to the corporation as an ex-
3 pense in computing taxable income under section
4 1363(b) in the year such distribution is received.”.

5 (b) CONFORMING AMENDMENTS.—

6 (1) Paragraph (1) of section 1361(b) is amend-
7 ed by inserting “, except as provided in subsection
8 (f),” before “which does not”.

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 (as defined in section 1361(f)) shall
14 not, with respect to such stock, be allocated any of
15 the items described in paragraph (1).”.

16 (3) So much of clause (ii) of section
17 354(a)(2)(C) as precedes subclause (II) thereof is
18 amended to read as follows:

19 “(ii) RECAPITALIZATION OF FAMILY-
20 OWNED CORPORATIONS AND S CORPORA-
21 TIONS.—

22 “(I) IN GENERAL.—Clause (i)
23 shall not apply in the case of a recap-
24 italization under section 368(a)(I)(E)

1 of a family-owned corporation or S
2 corporation.”.

3 (4) Subsection (a) of section 1373 is amended
4 by striking “and” at the end of paragraph (1), by
5 striking the period at the end of paragraph (2) and
6 inserting “, and”, and by adding at the end the fol-
7 lowing new paragraph:

8 “(3) no amount of an expense deductible under
9 this subchapter by reason of section 1361(f)(3) shall
10 be apportioned or allocated to such income.”.

11 (c) EFFECTIVE DATE.—The amendments made by
12 this section shall apply to taxable years beginning after
13 December 31, 2005.

14 **SEC. 4. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**
15 **IBLE DEBT.**

16 (a) IN GENERAL.—Subparagraph (B) of section
17 1361(c)(5) (defining straight debt) is amended by striking
18 clauses (ii) and (iii) and inserting the following new
19 clauses:

20 “(ii) in any case in which the terms of
21 such promise include a provision under
22 which the obligation to pay may be con-
23 verted (directly or indirectly) into stock of
24 the corporation, such terms, taken as a
25 whole, are substantially the same as the

1 terms which could have been obtained on
2 the effective date of the promise from a
3 person which is not a related person (with-
4 in the meaning of section 465(b)(3)(C)) to
5 the S corporation or its shareholders, and

6 “(iii) the creditor is—

7 “(I) an individual,

8 “(II) an estate,

9 “(III) a trust described in para-
10 graph (2),

11 “(IV) an exempt organization de-
12 scribed in paragraph (6), or

13 “(V) a person which is actively
14 and regularly engaged in the business
15 of lending money.”.

16 (b) EFFECTIVE DATE.—The amendment made by
17 this section shall apply to taxable years beginning after
18 December 31, 2005.

19 **SEC. 5. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**
20 **COME AS A TERMINATION EVENT.**

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

23 (b) CONFORMING AMENDMENTS.—

24 (1) Section 1362(f)(1) is amended by striking
25 “or (3)”.

1 (2) Clause (i) of section 1042(c)(4)(A) is
2 amended by striking “section 1362(d)(3)(C)” and
3 inserting “section 1375(b)(3)”.

4 (c) EFFECTIVE DATE.—The amendments made by
5 this section shall apply to taxable years beginning after
6 December 31, 2005.

7 **SEC. 6. MODIFICATIONS TO PASSIVE INCOME RULES.**

8 (a) INCREASED LIMIT.—

9 (1) IN GENERAL.—Paragraph (2) of section
10 1375(a) (relating to tax imposed when passive in-
11 vestment income of corporation having accumulated
12 earnings and profits exceeds 25 percent of gross re-
13 ceipts) is amended by striking “25 percent” and in-
14 serting “60 percent”.

15 (2) CONFORMING AMENDMENTS.—

16 (A) Subparagraph (J) of section 26(b)(2)
17 is amended by striking “25 percent” and insert-
18 ing “60 percent”.

19 (B) Clause (i) of section 1375(b)(1)(A) is
20 amended by striking “25 percent” and inserting
21 “60 percent”.

22 (C) The table of sections for part III of
23 subchapter S of chapter 1 is amended by strik-
24 ing “25 percent” in the item relating to section
25 1375 and inserting “60 percent”.

1 (b) REPEAL OF PASSIVE INCOME CAPITAL GAIN
2 CATEGORY.—

3 (1) IN GENERAL.—Subsection (b) of section
4 1375 (relating to tax imposed when passive invest-
5 ment income of corporation having accumulated
6 earnings and profits exceeds 60 percent of gross re-
7 ceipts), as amended by subsection (a), is amended by
8 striking paragraphs (3) and (4) and inserting the
9 following new paragraph:

10 “(3) PASSIVE INVESTMENT INCOME DE-
11 FINED.—

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

17 “(B) EXCEPTION FOR INTEREST ON
18 NOTES FROM SALES OF INVENTORY.—The term
19 ‘passive investment income’ shall not include in-
20 terest on any obligation acquired in the ordi-
21 nary course of the corporation’s trade or busi-
22 ness from its sale of property described in sec-
23 tion 1221(a)(1).

24 “(C) TREATMENT OF CERTAIN LENDING
25 OR FINANCE COMPANIES.—If the S corporation

1 meets the requirements of section 542(c)(6) for
2 the taxable year, the term ‘passive investment
3 income’ shall not include gross receipts for the
4 taxable year which are derived directly from the
5 active and regular conduct of a lending or fi-
6 nance business (as defined in section
7 542(d)(1)).

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

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

1 “(A) such sale is pursuant to an election
2 under section 1362(a) by the issuer of such
3 stock,

4 “(B) such sale is for fair market value at
5 the time of sale (as established by an inde-
6 pendent appraiser) and the terms of the sale
7 are otherwise at least as favorable to such trust
8 as the terms that would apply on a sale to an
9 unrelated party,

10 “(C) such trust does not pay any commis-
11 sions, costs, or other expenses in connection
12 with the sale, and

13 “(D) the stock is sold in a single trans-
14 action for cash not later than 120 days after
15 the S corporation election is made.”.

16 (c) EFFECTIVE DATE.—The amendments made by
17 this section shall take effect on the date of the enactment
18 of this Act.

19 **SEC. 8. ADJUSTMENT TO BASIS OF S CORPORATION STOCK**
20 **FOR CERTAIN CHARITABLE CONTRIBUTIONS.**

21 (a) IN GENERAL.—Paragraph (1) of section 1367(a)
22 (relating to adjustments to basis of stock of shareholders,
23 etc.) is amended by striking “and” at the end of subpara-
24 graph (B), by striking the period at the end of subpara-

1 graph (C) and inserting “, and”, and by adding at the
2 end the following new subparagraph:

3 “(D) the excess of the amount of the
4 shareholder’s proportionate share of any chari-
5 table contribution made by the S corporation
6 over the shareholder’s proportionate share of
7 the adjusted basis of the property contrib-
8 uted.”.

9 (b) EFFECTIVE DATE.—The amendments made by
10 this section shall apply to taxable years beginning after
11 December 31, 2005.

12 **SEC. 9. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**
13 **HOLDERS.**

14 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-
15 HOLDERS.—

16 (1) IN GENERAL.—Paragraph (1) of section
17 1361(b) (defining small business corporation) is
18 amended—

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

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

22 (C) by redesignating subparagraph (D) as
23 subparagraph (C).

24 (2) CONFORMING AMENDMENTS.—

1 (A) Paragraph (4) and (5)(A) of section
2 1361(c) (relating to special rules for applying
3 subsection (b)) are each amended by striking
4 “subsection (b)(1)(D)” and inserting “sub-
5 section (b)(1)(C)”.

6 (B) Clause (i) of section 280G(b)(5)(A)
7 (relating to general rule for exemption for small
8 business corporations, etc.) is amended by strik-
9 ing “but without regard to paragraph (1)(C)
10 thereof”.

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

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

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

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

19 (C) by adding at the end the following new
20 paragraph:

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

1 (2) PRO RATA SHARE OF S CORPORATION IN-
2 COME.—The last sentence of section 1441(b) (relat-
3 ing to income items) is amended to read as follows:
4 “In the case of a nonresident alien individual who is
5 a member of a domestic partnership or a share-
6 holder of an S corporation, the items of income re-
7 ferred to in subsection (a) shall be treated as refer-
8 ring to items specified in this subsection included in
9 his distributive share of the income of such partner-
10 ship or in his pro rata share of the income of such
11 S corporation.”.

12 (3) APPLICATION OF WITHHOLDING TAX ON
13 NONRESIDENT ALIEN SHAREHOLDERS.—Section
14 1446 (relating to withholding tax on foreign part-
15 ners’ share of effectively connected income) is
16 amended by redesignating subsection (f) as sub-
17 section (g) and by inserting after subsection (e) the
18 following new subsection:

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

21 “(1) an S corporation shall be treated as a
22 partnership,

23 “(2) the shareholders of such corporation shall
24 be treated as partners of such partnership,

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

“Sec. 1446. Withholding tax on foreign partners’ and S corporation share-
holders’ share of effectively connected income.”.

4 (C) PERMANENT ESTABLISHMENT OF
5 PARTNERS AND S CORPORATION SHARE-
6 HOLDERS.—Section 894 (relating to income af-
7 fected by treaty) is amended by redesignating
8 subsection (c) as subsection (d) and by insert-
9 ing after subsection (b) the following new sub-
10 section:

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

22 (c) APPLICATION OF OTHER WITHHOLDING TAX
23 RULES ON NONRESIDENT ALIEN SHAREHOLDERS.—

1 (1) SECTION 1441.—Section 1441 (relating to
2 withholding of tax on nonresident aliens) is amended
3 by redesignating subsection (g) as subsection (h)
4 and by inserting after subsection (f) the following
5 new subsection:

6 “(g) 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) no deduction or withholding under sub-
13 section (a) shall be required in the case of any item
14 of income realized by such corporation and allocable
15 to a shareholder which is an electing small business
16 trust (as defined in section 1361(e)).”.

17 (2) SECTION 1445.—Section 1445(e) (relating to
18 special rules relating to distributions, etc., by cor-
19 porations, partnerships, trusts, or estates) is amend-
20 ed by redesignating paragraph (6) as paragraph (7)
21 and by inserting after paragraph (5) the following
22 new paragraph:

23 “(6) S CORPORATION TREATED AS PARTNER-
24 SHIP, ETC.—For purposes of this section—

1 “(A) an S corporation shall be treated as
2 a partnership, and

3 “(B) the shareholders of such corporation
4 shall be treated as partners of such partnership,
5 and

6 “(C) no deduction or withholding under
7 subsection (a) shall be required in the case of
8 any gain realized by such corporation and allo-
9 cable to a shareholder which is an electing small
10 business trust (as defined in section 1361(e)).”.

11 (d) ADDITIONAL CONFORMING AMENDMENTS.—

12 (1) Section 1361(e)(2)(A)(i) is amended by
13 striking “who is a citizen or resident of the United
14 States”.

15 (2) Section 1361(d)(3)(B) is amended by strik-
16 ing “who is a citizen or resident of the United
17 States”.

18 (3) Section 1361(e)(2) is amended by inserting
19 “(including a nonresident alien)” after “person” the
20 first place it appears.

21 (e) EFFECTIVE DATE.—The amendments made by
22 this section shall apply to taxable years beginning after
23 December 31, 2005.

1 **SEC. 10. INADVERTENT INVALID ELECTIONS OR TERMI-**
 2 **NATIONS.**

3 (a) IN GENERAL.—Subsection (f) of section 1362 (re-
 4 lating to inadvertent invalid elections or terminations) is
 5 amended to read as follows:

6 “(f) INADVERTENT INVALID ELECTIONS OR TERMI-
 7 NATIONS.—

8 “(1) IN GENERAL.—If—

9 “(A) an election under subsection (a), sec-
 10 tion 1361(b)(3)(B)(ii), or section
 11 1361(c)(1)(A)(ii) by any corporation—

12 “(i) was not effective for the taxable
 13 year for which made (determined without
 14 regard to subsection (b)(2)) by reason of a
 15 failure to meet the requirements of section
 16 1361(b) or to obtain shareholder consents,
 17 or

18 “(ii) was terminated under paragraph
 19 (2) or (3) of subsection (d), section
 20 1361(b)(3)(C), or section
 21 1361(c)(1)(D)(iii),

22 “(B)(i) the Secretary determines that the
 23 circumstances resulting in such ineffectiveness
 24 or termination were inadvertent, and

25 “(ii) such circumstances occurred in a tax-
 26 able year for which a claim for credit or refund

1 under section 6511 has expired as of the date
2 of discovery referred to in subparagraph (C),

3 “(C) no later than a reasonable period of
4 time after discovery of the circumstances result-
5 ing in such ineffectiveness or termination, steps
6 were taken—

7 “(i) so that the corporation for which
8 the election was made or the termination
9 occurred is a small business corporation or
10 a qualified subchapter S subsidiary, as the
11 case may be, or

12 “(ii) to acquire the required share-
13 holder consents, and

14 “(D) the corporation for which the election
15 was made or the termination occurred, and
16 each person who was a shareholder in such cor-
17 poration at any time during the period specified
18 pursuant to this subsection, makes all adjust-
19 ments (necessary and consistent with the treat-
20 ment of such corporation as an S corporation or
21 a qualified subchapter S subsidiary, as the case
22 may be)—

23 “(i) for purposes of subpara-
24 graph (B)(i), as may be required by

1 the Secretary with respect to such pe-
2 riod, or

3 “(ii) for purposes of subpara-
4 graph (B)(ii), as if the corporation
5 was a S corporation or a qualified
6 subchapter S subsidiary for each tax-
7 able year for which a claim for credit
8 or refund pursuant to section 6511
9 has not expired at the time of the dis-
10 covery in paragraph (3) of this sub-
11 section,

12 then, notwithstanding the circumstances result-
13 ing in such ineffectiveness or termination, para-
14 graph (2) shall apply.

15 “(2) PERIOD FOR WHICH TREATED AS S COR-
16 PORATION.—If this paragraph applies to a corpora-
17 tion by reason of paragraph (1), such corporation
18 shall be treated as an S corporation or a qualified
19 subchapter S subsidiary, as the case may be—

20 “(A) for purposes of paragraph (1)(B)(i),
21 during the period specified by the Secretary,
22 and

23 “(B) for purposes of paragraph (1)(B)(ii),
24 for each taxable year for which a claim for
25 credit or return pursuant to section 6511 has

1 not expired at the time of the discovery referred
2 to in paragraph (1)(C).”.

3 (b) **EFFECTIVE DATE.**—The amendments made by
4 this section shall apply to taxable years beginning after
5 December 31, 2005.

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