

104TH CONGRESS
1ST SESSION

H. R. 2039

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

IN THE HOUSE OF REPRESENTATIVES

JULY 13, 1995

Mr. SHAW (for himself, Mr. MATSUI, Mr. PORTMAN, Mr. CHRISTENSEN, Mr. McDERMOTT, Mr. LEWIS of Georgia, Mr. LEVIN, Mr. HERGER, Mr. HANCOCK, Mr. THOMAS, Mr. BUNNING of Kentucky, Mr. ENGLISH of Pennsylvania, Mrs. MEYERS of Kansas, Mr. HOUGHTON, Mr. CAMP, Mr. SPRATT, Ms. DUNN of Washington, Mr. FUNDERBURK, Mr. CRANE, Mr. GORDON, Mr. PAYNE of Virginia, Mr. LONGLEY, Mr. NEAL of Massachusetts, Mrs. JOHNSON of Connecticut, Mr. McCRERY, Mr. KLECZKA, and Mr. ZIMMER) 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; 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 1995”.

1 (b) AMENDMENT OF 1986 CODE.—Except as other-
 2 wise expressly provided, whenever in this Act an amend-
 3 ment or repeal is expressed in terms of an amendment
 4 to, or repeal of, a section or other provision, the reference
 5 shall be considered to be made to a section or other provi-
 6 sion of the Internal Revenue Code of 1986.

7 (c) TABLE OF CONTENTS.—The table of contents is
 8 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 75 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. Treatment of distributions during loss years.
 Sec. 223. Consent dividend for AAA bypass election.
 Sec. 224. Treatment of S corporations under subchapter C.

Sec. 225. Elimination of pre-1983 earnings and profits.

Sec. 226. Allowance of charitable contributions of inventory and scientific property.

Sec. 227. C corporation rules to apply for fringe benefit purposes.

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 75**
 6 **SHAREHOLDERS.**

7 Subparagraph (A) of section 1361(b)(1) (defining
 8 small business corporation) is amended by striking “35
 9 shareholders” and inserting “75 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)—

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

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

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

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

23 “(D) EFFECT OF ADOPTION, ETC.—In de-
24 termining whether any relationship specified in

1 subparagraph (B) or (C) exists, the rules of
2 section 152(b)(2) shall apply.

3 “(E) ELECTION.—An election under sub-
4 paragraph (A)(ii)—

5 “(i) must be made with the consent of
6 all shareholders,

7 “(ii) shall remain in effect until termi-
8 nated, and

9 “(iii) shall apply only with respect to
10 1 family in any corporation.”.

11 **Subtitle B—Persons Allowed as** 12 **Shareholders**

13 **SEC. 111. CERTAIN EXEMPT ORGANIZATIONS.**

14 (a) CERTAIN EXEMPT ORGANIZATIONS ALLOWED TO
15 BE SHAREHOLDERS.—

16 (1) IN GENERAL.—Subparagraph (B) of section
17 1361(b)(1) (defining small business corporation) is
18 amended to read as follows:

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

23 (2) ELIGIBLE EXEMPT ORGANIZATIONS.—Sec-
24 tion 1361(c) (relating to special rules for applying

1 subsection (b)) is amended by adding at the end the
2 following new paragraph:

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

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

17 (c) SPECIAL RULES APPLICABLE TO PARTNERSHIPS
18 AND S CORPORATIONS.—

19 (1) IN GENERAL.—Subsection (c) of section
20 512 (relating to unrelated business tax income) is
21 amended—

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

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

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

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

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

19 **SEC. 112. FINANCIAL INSTITUTIONS.**

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

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

1 **SEC. 113. NONRESIDENT ALIENS.**

2 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-
3 HOLDERS.—

4 (1) IN GENERAL.—Paragraph (1) of section
5 1361(b) (defining small business corporation) is
6 amended—

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

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

10 (C) by redesignating subparagraph (D) as
11 subparagraph (C).

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

17 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED
18 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED
19 STATES.—

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

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

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

25 (C) by adding at the end the following new
26 paragraph:

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

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

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

15 “(1) an S corporation shall be treated as a
16 partnership,

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

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

21 (3) CONFORMING AMENDMENTS.—

22 (A) The heading of section 875 is amended
23 to read as follows:

1 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**
 2 **AND TRUSTS; S CORPORATIONS.”**

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

5 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**
 6 **AND S CORPORATE SHAREHOLDERS’ SHARE**
 7 **OF EFFECTIVELY CONNECTED INCOME.”**

8 (4) CLERICAL AMENDMENTS.—

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

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

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

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

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

20 “(c) PERMANENT ESTABLISHMENT OF PARTNERS
 21 AND S CORPORATION SHAREHOLDERS.—If a partnership
 22 or S corporation has a permanent establishment in the
 23 United States (within the meaning of a treaty to which

1 the United States is a party) at any time during a taxable
2 year of such entity, a nonresident alien individual or for-
3 eign corporation which is a partner in such partnership,
4 or a nonresident alien individual who is a shareholder in
5 such S corporation, shall be treated as having a permanent
6 establishment in the United States for purposes of such
7 treaty.”

8 **SEC. 113. ELECTING SMALL BUSINESS TRUSTS.**

9 (a) **GENERAL RULE.**—Subparagraph (A) of section
10 1361(c)(2) (relating to certain trusts permitted as share-
11 holders) is amended by inserting after clause (iv) the fol-
12 lowing new clause:

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

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

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

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

4 “(e) ELECTING SMALL BUSINESS TRUST DE-
5 FINED.—

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

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

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

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

17 “(iii) an election under this subsection
18 applies to such trust.

19 “(B) CERTAIN TRUSTS NOT ELIGIBLE.—
20 The term ‘electing small business trust’ shall
21 not include—

22 “(i) any qualified subchapter S trust
23 (as defined in subsection (d)(3)) if an elec-
24 tion under subsection (d)(2) applies to any

1 corporation the stock of which is held by
2 such trust, and

3 “(ii) any trust exempt from tax under
4 this subtitle.

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

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

22 “(3) ELECTION.—An election under this sub-
23 section shall be made by the trustee in such manner
24 and form, and at such time, as the Secretary may
25 prescribe. Any such election shall apply to the tax-

1 able year of the trust for which made and all subse-
2 quent taxable years of such trust unless revoked
3 with the consent of the Secretary.

4 “(4) CROSS REFERENCE.—

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

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

9 “(d) SPECIAL RULES FOR TAXATION OF ELECTING
10 SMALL BUSINESS TRUSTS.—

11 “(1) IN GENERAL.—For purposes of this chap-
12 ter—

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

17 “(B) the amount of the tax imposed by
18 this chapter on such separate trust shall be de-
19 termined with the modifications of paragraph
20 (2).

21 “(2) MODIFICATIONS.—For purposes of para-
22 graph (1), the modifications of this paragraph are
23 the following:

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

5 “(B) The exemption amount under section
6 55(d) shall be zero.

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

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

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

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

19 No deduction or credit shall be allowed for any
20 amount not described in this paragraph, and no
21 item described in this paragraph shall be appor-
22 tioned to any beneficiary.

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

1 “(3) TREATMENT OF REMAINDER OF TRUST
2 AND DISTRIBUTIONS.—For purposes of determin-
3 ing—

4 “(A) the amount of the tax imposed by
5 this chapter on the portion of any electing small
6 business trust not treated as a separate trust
7 under paragraph (1), and

8 “(B) the distributable net income of the
9 entire trust,

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

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

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

1 **Subtitle C—Other Provisions**

2 **SEC. 121. EXPANSION OF POST-DEATH QUALIFICATION FOR**
3 **CERTAIN TRUSTS.**

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

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

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

10 **TITLE II—QUALIFICATION AND**
11 **ELIGIBILITY REQUIREMENTS**
12 **FOR S CORPORATIONS**

13 **Subtitle A—One Class of Stock**

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

15 (a) IN GENERAL.—Section 1361 is amended by add-
16 ing at the end the following new subsection:

17 “(f) TREATMENT OF QUALIFIED PREFERRED
18 STOCK.—

19 “(1) IN GENERAL.—For purposes of this sub-
20 chapter—

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

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

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

8 “(3) DISTRIBUTIONS.—A distribution (not in
9 part or full payment in exchange for stock) made by
10 the corporation with respect to qualified preferred
11 stock shall be includible as interest income of the
12 holder and deductible to the corporation as interest
13 expense in computing taxable income under section
14 1363(b) in the year such distribution is received.

15 “(4) REGULATIONS.—The Secretary shall pre-
16 scribe such regulations as may be necessary or ap-
17 propriate to provide for the proper treatment of
18 qualified preferred stock under this title and for the
19 coordination of such treatment with other provisions
20 of this title.”

21 (b) CONFORMING AMENDMENTS.—

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

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

3 “(3) ALLOCATION WITH RESPECT TO QUALI-
4 FIED PREFERRED STOCK.—The holders of qualified
5 preferred stock (as defined in section 1361(f)) shall
6 not, with respect to such stock, be allocated any of
7 the items described in paragraph (1).”

8 **SEC. 202. FINANCIAL INSTITUTIONS PERMITTED TO HOLD**
9 **SAFE HARBOR DEBT.**

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

14 “(ii) in any case in which the terms of
15 such promise include a provision under
16 which the obligation to pay may be con-
17 verted (directly or indirectly) into stock of
18 the corporation, such terms, taken as a
19 whole, are substantially the same as the
20 terms which could have been obtained on
21 the effective date of the promise from a
22 person which is not a related person (with-
23 in the meaning of section 465(b)(3)(C)) to
24 the S corporation or its shareholders, and

25 “(iii) the creditor is—

- 1 “(I) an individual,
2 “(II) an estate,
3 “(III) a trust described in para-
4 graph (2), or
5 “(IV) a person which is actively
6 and regularly engaged in the business
7 of lending money.”

8 **Subtitle B—Elections and** 9 **Terminations**

10 **SEC. 211. RULES RELATING TO INADVERTENT TERMI-** 11 **NATIONS AND INVALID ELECTIONS.**

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

15 “(f) INADVERTENT INVALID ELECTIONS OR TERMI-
16 NATIONS.—If—

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

19 “(A) was not effective for the taxable year
20 for which made (determined without regard to
21 subsection (b)(2)) by reason of a failure to meet
22 the requirements of section 1361(b) or to ob-
23 tain shareholder consents, or

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

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

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

8 “(A) so that the corporation is a small
9 business corporation, or

10 “(B) to acquire the required shareholder
11 consents, and

12 “(4) the corporation, and each person who was
13 a shareholder in the corporation at any time during
14 the period specified pursuant to this subsection,
15 agrees to make such adjustments (consistent with
16 the treatment of the corporation as an S corpora-
17 tion) as may be required by the Secretary with re-
18 spect to such period,

19 then, notwithstanding the circumstances resulting in such
20 ineffectiveness or termination, such corporation shall be
21 treated as an S corporation during the period specified
22 by the Secretary.”

23 (b) LATE ELECTIONS.—Subsection (b) of section
24 1362 is amended by adding at the end thereof the follow-
25 ing new paragraph:

1 “(5) AUTHORITY TO TREAT LATE ELECTIONS
2 AS TIMELY.—If—

3 “(A) an election under subsection (a) is
4 made for any taxable year (determined without
5 regard to paragraph (3)) after the date pre-
6 scribed by this subsection for making such elec-
7 tion for such taxable year, and

8 “(B) the Secretary determines that there
9 was reasonable cause for the failure to timely
10 make such election,

11 the Secretary may treat such election as timely
12 made for such taxable year (and paragraph (3) shall
13 not apply).”

14 (c) AUTOMATIC WAIVERS.—The Secretary of the
15 Treasury shall provide for an automatic waiver procedure
16 under section 1362(f) of the Internal Revenue Code of
17 1986 in cases in which the Secretary determines appro-
18 priate.

19 (d) EFFECTIVE DATE.—The amendments made by
20 subsections (a) and (b) shall apply with respect to elec-
21 tions for taxable years beginning after December 31,
22 1982.

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

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

1 “(2) ELECTION TO TERMINATE YEAR.—

2 “(A) IN GENERAL.—Under regulations
3 prescribed by the Secretary, if any shareholder
4 terminates the shareholder’s interest in the cor-
5 poration during the taxable year and all af-
6 fected shareholders agree to the application of
7 this paragraph, paragraph (1) shall be applied
8 to the affected shareholders as if the taxable
9 year consisted of 2 taxable years the first of
10 which ends on the date of the termination.

11 “(B) AFFECTED SHAREHOLDERS.—For
12 purposes of subparagraph (A), the term ‘af-
13 fected shareholders’ means the shareholder
14 whose interest is terminated and all sharehold-
15 ers to whom such shareholder has transferred
16 shares during the taxable year. If such share-
17 holder has transferred shares to the corpora-
18 tion, the term ‘affected shareholders’ shall in-
19 clude all persons who are shareholders during
20 the taxable year.”

21 **SEC. 213. EXPANSION OF POST-TERMINATION TRANSITION**
22 **PERIOD.**

23 (a) IN GENERAL.—Paragraph (1) of section 1377(b)
24 (relating to post-termination transition period) is amended
25 by striking “and” at the end of subparagraph (A), by re-

1 designating subparagraph (B) as subparagraph (C), and
2 by inserting after subparagraph (A) the following new sub-
3 paragraph:

4 “(B) the 120-day period beginning on the
5 date of any determination pursuant to an audit
6 of the taxpayer which follows the termination of
7 the corporation’s election and which adjusts a
8 subchapter S item of income, loss, or deduction
9 of the corporation arising during the S period
10 (as defined in section 1368(e)(2)), and”.

11 (b) DETERMINATION DEFINED.—Paragraph (2) of
12 section 1377(b) is amended by striking subparagraphs (A)
13 and (B), by redesignating subparagraph (C) as subpara-
14 graph (B), and by inserting before subparagraph (B) (as
15 so redesignated) the following new subparagraph:

16 “(A) a determination as defined in section
17 1313(a), or”.

18 (c) REPEAL OF SPECIAL AUDIT PROVISIONS FOR
19 SUBCHAPTER S ITEMS.—

20 (1) GENERAL RULE.—Subchapter D of chapter
21 63 (relating to tax treatment of subchapter S items)
22 is hereby repealed.

23 (2) CONSISTENT TREATMENT REQUIRED.—Sec-
24 tion 6037 (relating to return of S corporation), as

1 amended by section 111(c)(2), is amended by adding
2 at the end the following new subsection:

3 “(d) SHAREHOLDER’S RETURN MUST BE CONSIST-
4 ENT WITH CORPORATE RETURN OR SECRETARY NOTI-
5 FIED OF INCONSISTENCY.—

6 “(1) IN GENERAL.—A shareholder of an S cor-
7 poration shall, on such shareholder’s return, treat a
8 subchapter S item in a manner which is consistent
9 with the treatment of such item on the corporate re-
10 turn.

11 “(2) NOTIFICATION OF INCONSISTENT TREAT-
12 MENT.—

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

15 “(i)(I) the corporation has filed a re-
16 turn but the shareholder’s treatment on
17 his return is (or may be) inconsistent with
18 the treatment of the item on the corporate
19 return, or

20 “(II) the corporation has not filed a
21 return, and

22 “(ii) the shareholder files with the
23 Secretary a statement identifying the in-
24 consistency,

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

1 “(B) SHAREHOLDER RECEIVING INCOR-
2 RECT INFORMATION.—A shareholder shall be
3 treated as having complied with clause (ii) of
4 subparagraph (A) with respect to a subchapter
5 S item if the shareholder—

6 “(i) demonstrates to the satisfaction
7 of the Secretary that the treatment of the
8 subchapter S item on the shareholder’s re-
9 turn is consistent with the treatment of the
10 item on the schedule furnished to the
11 shareholder by the corporation, and

12 “(ii) elects to have this paragraph
13 apply with respect to that item.

14 “(3) EFFECT OF FAILURE TO NOTIFY.—In any
15 case—

16 “(A) described in subparagraph (A)(i)(I)
17 of paragraph (2), and

18 “(B) in which the shareholder does not
19 comply with subparagraph (A)(ii) of paragraph
20 (2),

21 any adjustment required to make the treatment of
22 the items by such shareholder consistent with the
23 treatment of the items on the corporate return shall
24 be treated as arising out of mathematical or clerical
25 errors and assessed according to section 6213(b)(1).

1 Paragraph (2) of section 6213(b) shall not apply to
2 any assessment referred to in the preceding sen-
3 tence.

4 “(4) SUBCHAPTER S ITEM.—For purposes of
5 this subsection, the term ‘subchapter S item’ means
6 any item of an S corporation to the extent that reg-
7 ulations prescribed by the Secretary provide that, for
8 purposes of this subtitle, such item is more appro-
9 priately determined at the corporation level than at
10 the shareholder level.

11 “(5) ADDITION TO TAX FOR FAILURE TO COM-
12 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.”**

13 (3) CONFORMING AMENDMENTS.—

14 (A) Section 1366 is amended by striking
15 subsection (g).

16 (B) Subsection (b) of section 6233 is
17 amended to read as follows:

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

1 (C) The table of subchapters for chapter
2 63 is amended by striking the item relating to
3 subchapter D.

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

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

8 (b) MODIFICATION OF TAX IMPOSED ON EXCESSIVE
9 PASSIVE INVESTMENT INCOME.—

10 (1) INCREASE IN THRESHOLD.—Subsections
11 (a)(2) and (b)(1)(A)(i) of section 1375 (relating to
12 tax imposed when passive investment income of a
13 corporation having subchapter C earnings and prof-
14 its exceeds 25 percent of gross receipts) are each
15 amended by striking “25 percent” and inserting “50
16 percent”.

17 (2) TAX RATE INCREASE AFTER THIRD CON-
18 SECUTIVE YEAR.—Section 1375 is amended by re-
19 designating subsections (c) and (d) as subsections
20 (d) and (e), respectively, and by inserting after sub-
21 section (b) the following new subsection:

22 “(c) TAX RATE INCREASE AFTER THIRD CONSECU-
23 TIVE YEAR.—

24 “(1) IN GENERAL.—If an S corporation is de-
25 scribed in subsection (a) for more than 3 consecutive

1 taxable years, then the rate of tax imposed under
 2 subsection (a) with respect to each succeeding con-
 3 secutive taxable year (if any) shall be determined
 4 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.

5 “(2) YEARS TAKEN INTO ACCOUNT.—No tax
 6 shall be increased under paragraph (1) for any tax-
 7 able year beginning before January 1, 1996.”

8 (c) CONFORMING AMENDMENTS.—

9 (1) Section 1362(f)(1) is amended by striking
 10 “or (3)”.

11 (2) Subsection (b) of section 1375 is amended
 12 by striking paragraphs (3) and (4) and inserting the
 13 following new paragraphs:

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

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

7 “(5) PASSIVE INVESTMENT INCOME DE-
8 FINED.—

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

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

21 “(C) TREATMENT OF CERTAIN LENDING
22 OR FINANCE COMPANIES.—If the S corporation
23 meets the requirements of section 542(c)(6) for
24 the taxable year, the term ‘passive investment
25 income’ shall not include gross receipts for the

1 taxable year which are derived directly from the
2 active and regular conduct of a lending or fi-
3 nance business (as defined in section
4 542(d)(1)).

5 “(D) SPECIAL RULE FOR OPTIONS AND
6 COMMODITY DEALINGS.—

7 “(i) IN GENERAL.—In the case of any
8 options dealer or commodities dealer, pas-
9 sive investment income shall be determined
10 by not taking into account any gain or loss
11 (in the normal course of the taxpayer’s ac-
12 tivity of dealing in or trading section 1256
13 contracts) from any section 1256 contract
14 or property related to such a contract.

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

17 “(I) OPTIONS DEALER.—The
18 term ‘options dealer’ has the meaning
19 given such term by section
20 1256(g)(8).

21 “(II) COMMODITIES DEALER.—
22 The term ‘commodities dealer’ means
23 a person who is actively engaged in
24 trading section 1256 contracts and is
25 registered with a domestic board of

1 trade which is designated as a con-
2 tract market by the Commodities Fu-
3 tures Trading Commission.

4 “(III) SECTION 1256 CON-
5 TRACT.—The term ‘section 1256 con-
6 tract’ has the meaning given to such
7 term by section 1256(b).

8 “(E) COORDINATION WITH SECTION
9 1374.—The amount of passive investment in-
10 come shall be determined by not taking into ac-
11 count any recognized built-in gain or loss of the
12 S corporation for any taxable year in the rec-
13 ognition period. Terms used in the preceding
14 sentence shall have the same respective mean-
15 ing as when used in section 1374.”

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

18 (4) The table of sections for part III of sub-
19 chapter S of chapter 1 is amended by striking “25”
20 in the item relating to section 1375 and inserting
21 “50”.

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

1 **Subtitle C—Other Provisions**

2 **SEC. 221. S CORPORATIONS PERMITTED TO HOLD SUBSIDI-**
3 **ARIES.**

4 (a) IN GENERAL.—Paragraph (2) of section 1361(b)
5 (defining ineligible corporation), as amended by section
6 112, is amended by striking subparagraph (A) and by re-
7 designating subparagraphs (B), (C), (D), and (E) as sub-
8 paragraphs (A), (B), (C), and (D), respectively.

9 (b) TREATMENT OF CERTAIN WHOLLY OWNED S
10 CORPORATION SUBSIDIARIES.—Section 1361(b) (defining
11 small business corporation) is amended by adding at the
12 end thereof the following new subsection:

13 “(3) TREATMENT OF CERTAIN WHOLLY OWNED
14 SUBSIDIARIES.—

15 “(A) IN GENERAL.—For purposes of this
16 title—

17 “(i) a corporation which is a qualified
18 subchapter S subsidiary shall not be treat-
19 ed as a separate corporation, and

20 “(ii) all assets, liabilities, and items of
21 income, deduction, and credit of a qualified
22 subchapter S subsidiary shall be treated as
23 assets, liabilities, and such items (as the
24 case may be) of the S corporation.

1 “(B) QUALIFIED SUBCHAPTER S SUBSIDI-
2 ARY.—For purposes of this subsection, the term
3 ‘qualified subchapter S subsidiary’ means any
4 corporation 100 percent of the stock of which
5 is held by an S corporation as of the later of
6 the effective date of the S election of the S cor-
7 poration or the acquisition of the subsidiary,
8 and at all times thereafter.

9 “(C) TREATMENT OF TERMINATIONS OF
10 QUALIFIED SUBCHAPTER S SUBSIDIARY STA-
11 TUS.—For purposes of this subtitle, if any cor-
12 poration which was a qualified subchapter S
13 subsidiary ceases to meet the requirements of
14 subparagraph (B), such corporation shall be
15 treated as a new corporation acquiring all of its
16 assets (and assuming all of its liabilities) imme-
17 diately before such cessation from the S cor-
18 poration in exchange for its stock.”.

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

24 “(F) TREATMENT OF CERTAIN DIVI-
25 DENDS.—If an S corporation holds stock in a

1 C corporation meeting the requirements of sec-
2 tion 1504(a)(2), the term ‘passive investment
3 income’ shall not include dividends from such C
4 corporation to the extent such dividends are at-
5 tributable to the earnings and profits of such C
6 corporation derived from the active conduct of
7 a trade or business.”

8 (d) CONFORMING AMENDMENTS.—

9 (1) Subsection (c) of section 1361, as amended
10 by sections 111(a)(2) and 201(a), is amended by
11 striking paragraph (6) and redesignating paragraph
12 (7) as paragraphs (6).

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

16 “(8) An S corporation.”

17 **SEC. 222. TREATMENT OF DISTRIBUTIONS DURING LOSS**
18 **YEARS.**

19 (a) ADJUSTMENTS FOR DISTRIBUTIONS TAKEN INTO
20 ACCOUNT BEFORE LOSSES.—

21 (1) Subparagraph (A) of section 1366(d)(1)
22 (relating to losses and deductions cannot exceed
23 shareholder’s basis in stock and debt) is amended by
24 striking “paragraph (1)” and inserting “paragraphs
25 (1) and (2)(A)”.

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

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

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

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

13 “(i) IN GENERAL.—In applying this section
14 to distributions made during any taxable year,
15 the amount in the accumulated adjustments ac-
16 count as of the close of such taxable year shall
17 be determined without regard to any net nega-
18 tive adjustment for such taxable year.

19 “(ii) NET NEGATIVE ADJUSTMENT.—For
20 purposes of clause (i), the term ‘net negative
21 adjustment’ means, with respect to any taxable
22 year, the excess (if any) of—

23 “(I) the reductions in the account for
24 the taxable year (other than for distribu-
25 tions), over

1 “(II) the increases in such account for
2 such taxable year.”

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

5 (1) by striking “as provided in subparagraph
6 (B)” and inserting “as otherwise provided in this
7 paragraph”, and

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

10 **SEC. 223. CONSENT DIVIDEND FOR AAA BYPASS ELECTION.**

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

14 “(C) CONSENT DIVIDEND.—Under regula-
15 tions prescribed by the Secretary, an S corpora-
16 tion may, subject to the election under this
17 paragraph, consent to treat as a distribution
18 the amount specified in such consent, to the ex-
19 tent such amount does not exceed the accumu-
20 lated earnings and profits of such corporation.
21 The amount so specified shall be considered—

22 “(i) as distributed in money by the
23 corporation to its shareholders on the last
24 day of the taxable year of the corporation
25 and as contributed to the capital of the

1 corporation by the shareholders on such
2 day, and

3 “(ii) if any such shareholder is an or-
4 ganization described in section 511(a)(2),
5 as unrelated business taxable income (as
6 defined in section 512) to such share-
7 holder.”

8 **SEC. 224. TREATMENT OF S CORPORATIONS UNDER SUB-**
9 **CHAPTER C.**

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

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

16 **SEC. 225. ELIMINATION OF PRE-1983 EARNINGS AND**
17 **PROFITS.**

18 (a) IN GENERAL.—If—

19 (1) a corporation was an electing small business
20 corporation under subchapter S of chapter 1 of the
21 Internal Revenue Code of 1986 for any taxable year
22 beginning before January 1, 1983, and

23 (2) such corporation is an S corporation under
24 subchapter S of chapter 1 of such Code for its first
25 taxable year beginning after December 31, 1995,

1 the amount of such corporation's accumulated earnings
2 and profits (as of the beginning of such first taxable year)
3 shall be reduced by an amount equal to the portion (if
4 any) of such accumulated earnings and profits which were
5 accumulated in any taxable year beginning before January
6 1, 1983, for which such corporation was an electing small
7 business corporation under such subchapter S.

8 (b) CONFORMING AMENDMENTS.—

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

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

16 (C) The section heading for section 1375 is
17 amended by striking “**SUBCHAPTER C**” and insert-
18 ing “**ACCUMULATED**”.

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

23 (2) Clause (i) of section 1042(c)(4)(A), as
24 amended by section 214(c)(5), is amended by strik-

1 ing “section 1375(b)(5)” and inserting “section
2 1375(b)(4)”.

3 **SEC. 226. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**
4 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

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

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

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

14 (b) STOCK BASIS ADJUSTMENT.—Paragraph (1) of
15 section 1367(a) (relating to adjustments to basis of stock
16 of shareholders, etc.) is amended by striking “and” at the
17 end of subparagraph (B), by striking the period at the
18 end of subparagraph (C) and inserting “, and”, and by
19 adding at the end the following new subparagraph:

20 “(D) the excess of the deductions for char-
21 itable contributions over the basis of the prop-
22 erty contributed.”

1 **SEC. 227. C CORPORATION RULES TO APPLY FOR FRINGE**
2 **BENEFIT PURPOSES.**

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

5 (b) PARTNERSHIP RULES TO APPLY FOR HEALTH
6 INSURANCE COSTS OF CERTAIN S CORPORATION SHARE-
7 HOLDERS.—Paragraph (5) of section 162(*l*) is amended
8 to read as follows:

9 “(5) TREATMENT OF CERTAIN S CORPORATION
10 SHAREHOLDERS.—

11 “(A) IN GENERAL.—This subsection shall
12 apply in the case of any 2-percent shareholder
13 of an S corporation, except that—

14 “(i) for purposes of this subsection,
15 such shareholder’s wages (as defined in
16 section 3121) from the S corporation shall
17 be treated as such shareholder’s earned in-
18 come (within the meaning of section
19 401(c)(1)), and

20 “(ii) there shall be such adjustments
21 in the application of this subsection as the
22 Secretary may by regulations prescribe.

23 “(B) 2-PERCENT SHAREHOLDER DE-
24 FINED.—For purposes of this paragraph, the
25 term ‘2-percent shareholder’ means any person
26 who owns (or is considered as owning within

1 the meaning of section 318) on any day during
2 the taxable year of the S corporation more than
3 2 percent of the outstanding stock of such cor-
4 poration or stock possessing more than 2 per-
5 cent of the total combined voting power of all
6 stock of such corporation.”

7 (b) CONFORMING AMENDMENT.—The table of sec-
8 tions for part III of subchapter S of chapter 1 is amended
9 by striking the item relating to section 1372.

10 **TITLE III—TAXATION OF S** 11 **CORPORATION SHAREHOLDERS**

12 **SEC. 301. UNIFORM TREATMENT OF OWNER-EMPLOYEES** 13 **UNDER PROHIBITED TRANSACTION RULES.**

14 The last sentence of section 4975(d) (relating to ex-
15 emptions from prohibited transactions) is amended by
16 striking “a shareholder-employee (as defined in section
17 1379, as in effect on the day before the date of the enact-
18 ment of the Subchapter S Revision Act of 1982),”.

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

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

1 “(c) LOSSES ON LIQUIDATIONS OF S CORPORA-
2 TION.—

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

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

22 (b) CARRYOVER OF DISALLOWED LOSSES AND DE-
23 Ductions UNDER AT-RISK RULES ALLOWED.—Para-
24 graph (3) of section 1366(d) (relating to carryover of dis-
25 allowed losses and deductions to post-termination transi-

1 tion period) is amended by adding at the end the following
2 new subparagraph:

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

13 **TITLE IV—EFFECTIVE DATE**

14 **SEC. 401. EFFECTIVE DATE.**

15 (a) IN GENERAL.—Except as otherwise provided in
16 this Act, the amendments made by this Act shall apply
17 to taxable years beginning after December 31, 1995.

18 (b) TREATMENT OF CERTAIN ELECTIONS UNDER
19 PRIOR LAW.—For purposes of section 1362(g) of the In-
20 ternal Revenue Code of 1986 (relating to election after
21 termination), any termination or revocation under section
22 1362(d) of such Code (as in effect on the day before the
23 date of the enactment of this Act) shall not be taken into
24 account.

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