

105TH CONGRESS  
2D SESSION

# H. R. 4285

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

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## IN THE HOUSE OF REPRESENTATIVES

JULY 21, 1998

Mr. SHAW (for himself, Mr. MATSUI, Mr. PORTMAN, Mr. NEAL of Massachusetts, Mr. CAMP, Ms. DUNN, Mr. HERGER, Mr. BUNNING, Mr. LEVIN, Mr. THOMAS, Mr. HOUGHTON, Mr. HALL of Texas, Mr. KLECZKA, Mr. WATKINS, and Mr. ENSIGN) introduced the following bill; which was referred to the Committee on Ways and Means

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## 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  
6 “Subchapter S Revision Act of 1998”.

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 is  
 5 as follows:

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

#### TITLE I—SUBCHAPTER S EXPANSION

##### Subtitle A—Eligible Shareholders of an S Corporation

Sec. 101. Members of a family treated as one shareholder.

Sec. 102. Nonresident aliens.

##### Subtitle B—Qualification and Eligibility Requirements of S Corporations

Sec. 111. Issuance of preferred stock permitted.

Sec. 112. Safe harbor debt expanded to include convertible debt.

Sec. 113. Repeal of excessive passive investment income as termination event.

Sec. 114. Repeal passive income capital gain category.

Sec. 115. Allowance of charitable contributions of inventory and scientific prop-  
 erty.

Sec. 116. C corporation rules to apply for fringe benefit purposes.

##### Subtitle C—Taxation of S Corporation Shareholders

Sec. 120. Treatment of losses to shareholders.

##### Subtitle D—Effective Date

Sec. 130. Effective Date.

#### TITLE II—SENSE OF THE HOUSE OF REPRESENTATIVES RESOLUTION

Sec. 201. Sense of the House of Representatives resolution opposing the admin-  
 istration's proposal to treat Subchapter S elections as taxable  
 liquidations of C corporations.

1                   **TITLE I—SUBCHAPTER S**  
2                                   **EXPANSION**  
3       **Subtitle A—Eligible Shareholders**  
4                                   **of an S Corporation**

5       **SEC. 101. MEMBERS OF FAMILY TREATED AS 1 SHARE-**  
6                                   **HOLDER.**

7           Paragraph (1) of section 1361(c) (relating to special  
8 rules for applying subsection (b)) is amended to read as  
9 follows:

10                   “(1) MEMBERS OF FAMILY TREATED AS 1  
11                   SHAREHOLDER.—

12                                   “(A) IN GENERAL.—For purpose of sub-  
13                                   section (b)(1)(A)—

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

17   “(ii) in the case of a family with re-  
18   spect to which an election is in effect  
19   under subparagraph (E), all members of  
20   the family shall be treated as 1 share-  
21   holder.

22                                   “(B) MEMBERS OF THE FAMILY.—For  
23                                   purpose of subparagraph (A)(ii), the term  
24                                   ‘members of the family’ means the lineal de-  
25                                   scendants of the common ancestor and the

1 spouses (or former spouses) of such lineal de-  
2 scendants or common ancestor.

3 “(C) COMMON ANCESTOR.—For purposes  
4 of this paragraph, an individual shall not be  
5 considered a common ancestor if, as of the later  
6 of the effective date of this paragraph or the  
7 time the election under section 1362(a) is  
8 made, the individual is more than 6 generations  
9 removed from the youngest generation of share-  
10 holders.

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

15 “(E) ELECTION.—An election under sub-  
16 paragraph (A)(ii)—

17 “(i) must be made with the consent of  
18 all shareholders,

19 “(ii) shall remain in effect until termi-  
20 nated, and

21 “(iii) shall apply only with respect to  
22 1 family in any corporation.”.

1 **SEC. 102. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**  
2 **HOLDERS.**

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

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

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

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

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

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

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

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

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

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

1 (C) by adding at the end the following new  
2 paragraph:

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

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

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

17 “(1) an S corporation shall be treated as a  
18 partnership,

19 “(2) the shareholders of such corporation shall  
20 be treated as partners of such partnership; and

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

23 (3) CONFORMING AMENDMENTS.—

24 (A) The heading of section 875 is amended  
25 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 CORPORATION SHAREHOLDERS’**  
 7 **SHARE OF EFFECTIVELY CONNECTED IN-**  
 8 **COME.”**

9 (4) CLERICAL AMENDMENTS.—

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

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

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

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

17 (C) PERMANENT ESTABLISHMENT OF  
 18 PARTNERS AND S CORPORATION SHAREHOLD-  
 19 ERS. Section 894 (relating to income affected  
 20 by treaty) is amended by redesignating sub-  
 21 section 894(e) as subsection 894(d) and insert-  
 22 ing the following new subsection after sub-  
 23 section 894(b):

1       “(c) PERMANENT ESTABLISHMENT OF PARTNERS  
2 AND S CORPORATION SHAREHOLDERS.—If a partnership  
3 of S corporation has a permanent establishment in the  
4 United States (within the meaning of a treaty to which  
5 the United States is a party) at any time during a taxable  
6 year of such entity, a nonresident alien individual or for-  
7 eign corporation which is a partner in such partnership,  
8 or a nonresident alien individual who is a shareholder in  
9 such S corporation, shall be treated as having a permanent  
10 establishment in the United States for purposes of such  
11 treaty.”

12       **Subtitle B—Qualification and Eligi-**  
13       **bility Requirements of S Cor-**  
14       **porations**

15       **SEC. 111. ISSUANCE OF PREFERRED STOCK PERMITTED.**

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

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

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

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

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

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

11          “(3) DISTRIBUTIONS.—A distribution (not in  
12          part or full payment in exchange for stock) made by  
13          the corporation with respect to qualified preferred  
14          stock shall be includible as ordinary income of the  
15          holder and deductible to the corporation as an ex-  
16          pense in computing taxable income under section  
17          1363(b) in the year such distribution is received.”

18          (b) CONFORMING AMENDMENTS.—

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

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

24                 “(3) ALLOCATION WITH RESPECT TO QUALI-  
25                 FIED PREFERRED STOCK.—The holders of qualified

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

4 (3) The title to clause (ii) to subparagraph (C)  
5 of section 354(a)(2) and part I of such clause (ii)  
6 are amended to read as follows:

7 “(ii) RECAPITALIZATION OF FAMILY-  
8 OWNED CORPORATIONS AND S CORPORA-  
9 TIONS.—

10 (I) IN GENERAL.—Clause (I)  
11 shall not apply in the case of a recap-  
12 italization under section 368(a)(I)(E)  
13 of a family-owned corporation or S  
14 corporation.”

15 (4) Subsection (a) of Section 1373 is amended  
16 by striking “and” at the end of paragraph (1), strik-  
17 ing the period at the end of paragraph (2) and in-  
18 serting “, and” in its place, and adding at the end  
19 the following new paragraph:

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

1 **SEC. 112. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**  
2 **IBLE DEBT.**

3 Subparagraph (B) of section 1361(e)(5) (defining  
4 straight debt) is amended by adding “and” at the end of  
5 clause (I) and by striking clauses (ii) and (iii) and insert-  
6 ing the following:

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

18 “(iii) the creditor is—

19 “(I) an individual,

20 “(II) an estate,

21 “(III) a trust described in para-  
22 graph (2), or

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

1 **SEC. 113. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**  
2 **COME AS A TERMINATION EVENT.**

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

5 (b) CONFORMING AMENDMENTS.—

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

8 (2) Clause (I) of section 1042(c)(4)(A) is  
9 amended by striking “section 1362(d)(3)(D)” and  
10 inserting “section 1375(b)(5)”.

11 **SEC. 114. REPEAL PASSIVE INCOME CAPITAL GAIN CAT-**  
12 **EGORY.**

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

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

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

24 “(A) IN GENERAL.—Except as otherwise  
25 provided in this paragraph, the term ‘passive  
26 investment income’ means gross receipts de-

1 rived from royalties, rents, dividends, interest,  
2 and annuities.

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

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

19 “(D) TREATMENT OF CERTAIN DIVI-  
20 DENDS.—If an S corporation holds stock in a  
21 C corporation meeting the requirements of sec-  
22 tion 1504(a)(2), the term ‘passive investment  
23 income’ shall not include dividends from such C  
24 corporation to the extent such dividends are at-  
25 tributable to the earnings and profits of such C

1 corporations derived from the active conduct of  
2 a trade or business.

3 “(E) COORDINATION WITH SECTION  
4 1374.—The amount of passive investment in-  
5 come shall be determined by not taking into ac-  
6 count any recognized built-in gain or loss of the  
7 S corporation for any taxable year in the rec-  
8 ognition period. Terms used in the preceding  
9 sentence shall have the same respective mean-  
10 ing as when used in section 1374.”

11 **SEC. 115. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**  
12 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

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

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

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

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

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

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

6 **SEC. 116. C CORPORATION RULES TO APPLY FOR FRINGE**  
7 **BENEFIT PURPOSES.**

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

10 (b) PARTNERSHIP RULES TO APPLY FOR HEALTH  
11 INSURANCE COSTS OF CERTAIN S CORPORATION SHARE-  
12 HOLDERS.—Paragraph (5) of section 162(1) is amended  
13 to read as follows:

14 “(5) TREATMENT OF CERTAIN S CORPORATION  
15 SHAREHOLDERS.—

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

19 “(i) for purposes of this subsection,  
20 such shareholder’s wages (as defined in  
21 section 3121) from the S corporation shall  
22 be treated as such shareholder’s earned in-  
23 come (within the meaning of section  
24 401(c)(1)), and

1           “(ii) there shall be such adjustments  
2           in the application of this subsection as the  
3           Secretary may by regulations prescribe.

4           “(B) 2-PERCENT SHAREHOLDER DE-  
5           FINED.—For purposes of this paragraph, the  
6           term ‘2-percent shareholder’ means any person  
7           who owns (or is considered as owning within  
8           the meaning of section 318) on any day during  
9           the taxable year of the S corporation more than  
10          2 percent of the outstanding stock of such cor-  
11          poration or stock possessing more than 2 per-  
12          cent of the total combined voting power of all  
13          stock of such corporation.”

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

17                   **Subtitle C—Taxation of S**  
18                   **Corporation Shareholders**

19          **SEC. 120. TREATMENT OF LOSSES TO SHAREHOLDERS.**

20          (a) LIQUIDATIONS.—Section 331 (relating to gain or  
21          loss to shareholders in corporate liquidations) is amended  
22          by redesignating subsection (c) as subsection (d) and by  
23          inserting after subsection (b) the following new subsection:

24           “(c) LOSS ON LIQUIDATIONS OF S CORPORATION.—

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

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

20           (b) SUSPENDED PASSIVE ACTIVITY LOSSES.—Para-  
21           graph (3) of section 1371(b) is amended to read as fol-  
22           lows:

23           “(3) TREATMENT OF S YEAR AS ELAPSED  
24           YEAR; PASSIVE LOSSES.—Nothing in paragraphs (1)  
25           and (2) shall prevent treating a taxable year for

1       which a corporation is an S corporation as a taxable  
2       year for purposes of determining the number of tax-  
3       able years to which an item may be carried back or  
4       carried forward nor prevent the allowance of a pas-  
5       sive activity loss deduction to the extent provided by  
6       section 469(g).”

## 7                   **Subtitle D—Effective Date**

### 8       **SEC. 130. EFFECTIVE DATE.**

9           (a) **IN GENERAL.**—Except as otherwise provided in  
10       this Act, and in section 1362(g) relating to elections after  
11       termination, the amendments made by this Act shall apply  
12       to taxable years beginning after December 31, 1998.

13           (b) **TREATMENT OF CERTAIN ELECTIONS UNDER**  
14       **PRIOR LAW.**—For purposes of section 1362(g) of the In-  
15       ternal Revenue Code of 1986 (relating to election after  
16       termination), any termination or revocation under section  
17       1362(d) of such Code (as in effect on the day before enact-  
18       ment of this Act) shall not be taken into account.

1 **TITLE II—SENSE OF THE HOUSE**  
2 **OF REPRESENTATIVES RESO-**  
3 **LUTION**

4 **SEC. 201. SENSE OF THE HOUSE OF REPRESENTATIVES**  
5 **RESOLUTION OPPOSING THE ADMINISTRA-**  
6 **TION'S PROPOSAL TO TREAT SUBCHAPTER S**  
7 **ELECTIONS AS TAXABLE LIQUIDATIONS.**

8 To express the sense of the House of Representatives  
9 that the proposal in the President's Fiscal Year 1999  
10 budget to treat the conversion of certain "large" C cor-  
11 porations into S corporations as taxable liquidations would  
12 be harmful to the business community, would effectively  
13 prohibit many businesses from making S elections in the  
14 future, and should be rejected.

15 Whereas, the President's proposal would impose a  
16 "liquidation tax" upon C to S corporation conversions.

17 Whereas, the President's proposal would undermine  
18 the S corporation reform provisions included in the Small  
19 Business Job Protection Act of 1996.

20 Whereas, the President's proposal would curtail fu-  
21 ture conversion of businesses from C to S status.

22 Whereas, S corporations function as an integral and  
23 productive part of our domestic economy and their forma-  
24 tion and use should be encouraged.

1       *Resolved*, That it is the sense of the House of Rep-  
2   resentatives that the President’s “liquidation tax” pro-  
3   posal upon the conversion of C corporations to S status  
4   is ill-advised and should be rejected.

○