

108TH CONGRESS  
1ST SESSION

# H. R. 1896

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

APRIL 30, 2003

Mr. SHAW (for himself, Mr. MATSUI, Mr. MCINNIS, and Mrs. JONES of Ohio) 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 Modernization Act of 2003”.

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

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

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

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

#### TITLE I—ELIGIBLE SHAREHOLDERS OF AN S CORPORATION

Sec. 101. Members of family treated as 1 shareholder.

Sec. 102. Nonresident aliens allowed to be shareholders.

Sec. 103. Expansion of bank S corporation eligible shareholders to include IRAs.

Sec. 104. Increase in number of eligible shareholders to 150.

#### TITLE II—QUALIFICATION AND ELIGIBILITY REQUIREMENTS OF S CORPORATIONS

Sec. 201. Issuance of preferred stock permitted.

Sec. 202. Safe harbor expanded to include convertible debt.

Sec. 203. Repeal of excessive passive investment income as a termination event.

Sec. 204. Modifications to passive income rules.

Sec. 205. Adjustment to basis of S corporation stock for certain charitable contributions.

#### TITLE III—TREATMENT OF S CORPORATION SHAREHOLDERS

Sec. 301. Treatment of losses to shareholders.

Sec. 302. Transfer of suspended losses incident to divorce.

Sec. 303. Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries.

Sec. 304. Deductibility of interest expense incurred by an electing small business trust to acquire S corporation stock.

Sec. 305. Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT.

Sec. 306. Clarification of electing small business trust distribution rules.

Sec. 307. Allowance of charitable contributions deduction for electing small business trusts.

Sec. 308. Shareholder basis not increased by income derived from cancellation of S corporation's debt.

Sec. 309. Back to back loans as indebtedness.

#### TITLE IV—EXPANSION OF S CORPORATION ELIGIBILITY FOR BANKS

Sec. 401. Exclusion of investment securities income from passive income test for bank S corporations.

Sec. 402. Treatment of qualifying director shares.

Sec. 403. Recapture of bad debt reserves.

#### TITLE V—QUALIFIED SUBCHAPTER S SUBSIDIARIES

Sec. 501. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations.

Sec. 502. Information returns for qualified subchapter S subsidiaries.

Sec. 503. Treatment of the sale of interest in a qualified subchapter S subsidiary.

Sec. 504. Exception to application of step transaction doctrine for restructuring in connection with making qualified subchapter S subsidiary elections.

#### TITLE VI—ADDITIONAL PROVISIONS

Sec. 601. Elimination of all earnings and profits attributable to pre-1983 years.

Sec. 602. No gain or loss on deferred intercompany transactions because of conversion to S corporation or qualified S corporation subsidiary.

Sec. 603. Treatment of charitable contribution and foreign tax credit carryforwards.

Sec. 604. Distributions by an S corporation to an employee stock ownership plan.

Sec. 605. Special rules of application.

## 1 **TITLE I—ELIGIBLE SHARE-** 2 **HOLDERS OF AN S CORPORA-** 3 **TION**

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

6 (a) IN GENERAL.—Paragraph (1) of section 1361(c)  
7 (relating to special rules for applying subsection (b)) is  
8 amended to read as follows:

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

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

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

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

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

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

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

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

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

24                   “(i) must be made with the consent of  
25                   shareholders (including those that are fam-

1 ily members) holding in the aggregate  
2 more than one-half of the shares of stock  
3 in the corporation on the day the election  
4 is made,

5 “(ii) in the case of—

6 “(I) an electing small business  
7 trust, shall be made by the trustee of  
8 the trust, and

9 “(II) a qualified subchapter S  
10 trust, shall be made by the beneficiary  
11 of the trust,

12 “(iii) under regulations, shall remain  
13 in effect until terminated, and

14 “(iv) shall apply only with respect to  
15 1 family in any corporation.”.

16 (b) RELIEF FROM INADVERTENT INVALID ELECTION  
17 OR TERMINATION.—Section 1362(f) (relating to inad-  
18 vertent invalid elections or terminations), as amended by  
19 section 501, is amended—

20 (1) by inserting “or under section  
21 1361(c)(1)(A)(ii)” after “section 1361(b)(3)(B)(ii)”  
22 in paragraph (1), and

23 (2) by inserting “or under section  
24 1361(c)(1)(E)(iii)” after “section 1361(b)(3)(C)” in  
25 paragraph (1)(B).

1 (c) EFFECTIVE DATES.—

2 (1) SUBSECTION (a).—The amendment made  
3 by subsection (a) shall apply to taxable years begin-  
4 ning after December 31, 2003.

5 (2) SUBSECTION (b).—The amendments made  
6 by subsection (b) shall apply to elections and termi-  
7 nations made after December 31, 2003.

8 **SEC. 102. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**  
9 **HOLDERS.**

10 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-  
11 HOLDERS.—

12 (1) IN GENERAL.—Paragraph (1) of section  
13 1361(b) (defining small business corporation) is  
14 amended—

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

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

18 (C) by redesignating subparagraph (D) as  
19 subparagraph (C).

20 (2) CONFORMING AMENDMENTS.—Paragraph  
21 (4) and (5)(A) of section 1361(c) (relating to special  
22 rules for applying subsection (b)) are each amended  
23 by striking “subsection (b)(1)(D)” and inserting  
24 “subsection (b)(1)(C)”.

1 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED  
2 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED  
3 STATES.—

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

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

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

9 (C) by adding at the end the following new  
10 paragraph:

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

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

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

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

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

5 “(3) any reference to section 704 shall be treat-  
6 ed as a reference to section 1366, and

7 “(4) no withholding tax under subsection (a)  
8 shall be required in the case of any income realized  
9 by such corporation and allocable to a shareholder  
10 which is an electing small business trust (as defined  
11 in section 1361(e)).”.

12 (3) CONFORMING AMENDMENTS.—

13 (A) The heading of section 875 is amended  
14 to read as follows:

15 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES  
16 AND TRUSTS; S CORPORATIONS.”.**

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

19 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’  
20 AND S CORPORATION SHAREHOLDERS’  
21 SHARE OF EFFECTIVELY CONNECTED IN-  
22 COME.”.**

23 (4) CLERICAL AMENDMENTS.—

24 (A) The item relating to section 875 in the  
25 table of sections for subpart A of part II of

1 subchapter N of chapter 1 is amended to read  
2 as follows:

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

3 (B) The item relating to section 1446 in  
4 the table of sections for subchapter A of chap-  
5 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.”.

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

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

1 (c) APPLICATION OF OTHER WITHHOLDING TAX  
2 RULES ON NONRESIDENT ALIEN SHAREHOLDERS.—

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

8 “(g) S CORPORATION TREATED AS PARTNERSHIP,  
9 ETC.—For purposes of this section—

10 “(1) an S corporation shall be treated as a  
11 partnership,

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

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

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

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

3           “(A) an S corporation shall be treated as  
4 a partnership, and

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

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

13       (d) CONFORMING AMENDMENT.—Section 1361(e)(2)  
14 is amended by inserting “(including a nonresident alien)”  
15 after “person” the first place it appears.

16       (e) EFFECTIVE DATE.—The amendments made by  
17 this section shall apply to taxable years beginning after  
18 December 31, 2003.

19 **SEC. 103. EXPANSION OF BANK S CORPORATION ELIGIBLE**  
20 **SHAREHOLDERS TO INCLUDE IRAS.**

21       (a) IN GENERAL.—Section 1361(c)(2)(A) (relating to  
22 certain trusts permitted as shareholders) is amended by  
23 inserting after clause (v) the following new clause:

24           “(vi) In the case of a corporation  
25 which is a bank (as defined in section

1           581), a trust which constitutes an indi-  
2           vidual retirement account under section  
3           408(a), including one designated as a Roth  
4           IRA under section 408A, but only to the  
5           extent of the stock held by such trust in  
6           such bank as of the date of the enactment  
7           of this clause.”.

8           (b) TREATMENT AS SHAREHOLDER.—Section  
9   1361(c)(2)(B) (relating to treatment as shareholders) is  
10   amended by adding at the end the following new clause:

11                   “(vi) In the case of a trust described  
12                   in clause (vi) of subparagraph (A), the in-  
13                   dividual for whose benefit the trust was  
14                   created shall be treated as a shareholder.”.

15           (c) SALE OF STOCK IN IRA RELATING TO S COR-  
16   PORATION ELECTION EXEMPT FROM PROHIBITED  
17   TRANSACTION RULES.—Section 4975(d) (relating to ex-  
18   emptions) is amended by striking “or” at the end of para-  
19   graph (14), by striking the period at the end of paragraph  
20   (15) and inserting “; or”, and by adding at the end the  
21   following new paragraph:

22                   “(16) a sale of stock held by a trust which con-  
23                   stitutes an individual retirement account under sec-  
24                   tion 408(a) to the individual for whose benefit such

1 account is established if such sale is pursuant to an  
2 election under section 1362(a).”.

3 (d) CONFORMING AMENDMENT.—Section 512(e)(1)  
4 is amended by inserting “1361(c)(2)(A)(vi) or” before  
5 “1361(c)(6)”.

6 (e) EFFECTIVE DATE.—The amendments made by  
7 this section shall apply to trusts which constitute indi-  
8 vidual retirement accounts on the date of the enactment  
9 of this Act.

10 **SEC. 104. INCREASE IN NUMBER OF ELIGIBLE SHARE-**  
11 **HOLDERS TO 150.**

12 (a) IN GENERAL.—Section 1361(b)(1)(A) (defining  
13 small business corporation) is amended by striking “75”  
14 and inserting “150”.

15 (b) EFFECTIVE DATE.—The amendment made by  
16 this section shall apply to taxable years beginning after  
17 December 31, 2003.

18 **TITLE II—QUALIFICATION AND**  
19 **ELIGIBILITY REQUIREMENTS**  
20 **OF S CORPORATIONS**

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

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

1       “(f) TREATMENT OF QUALIFIED PREFERRED  
2 STOCK.—

3               “(1) IN GENERAL.—For purposes of this sub-  
4 chapter—

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

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

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

17               “(3) DISTRIBUTIONS.—A distribution (not in  
18 part or full payment in exchange for stock) made by  
19 the corporation with respect to qualified preferred  
20 stock shall be includible as ordinary income of the  
21 holder and deductible to the corporation as an ex-  
22 pense in computing taxable income under section  
23 1363(b) in the year such distribution is received.”.

24       (b) CONFORMING AMENDMENTS.—

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

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

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

11          (3) So much of clause (ii) of section  
12          354(a)(2)(C) as precedes subclause (II) is amended  
13          to read as follows:

14                       “(ii) RECAPITALIZATION OF FAMILY-  
15                       OWNED CORPORATIONS AND S CORPORA-  
16                       TIONS.—

17                               “(I) IN GENERAL.—Clause (i)  
18                               shall not apply in the case of a recapi-  
19                               talization under section 368(a)(I)(E)  
20                               of a family-owned corporation or S  
21                               corporation.”.

22          (4) Subsection (a) of section 1373 is amended  
23          by striking “and” at the end of paragraph (1), by  
24          striking the period at the end of paragraph (2) and

1 inserting “, and”, and by adding at the end the fol-  
2 lowing new paragraph:

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

6 (c) EFFECTIVE DATE.—The amendments made by  
7 this section shall apply to taxable years beginning after  
8 December 31, 2003.

9 **SEC. 202. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**  
10 **IBLE DEBT.**

11 (a) IN GENERAL.—Subparagraph (B) of section  
12 1361(c)(5) (defining straight debt) is amended by striking  
13 clauses (ii) and (iii) and inserting the following new  
14 clauses:

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

1 “(iii) the creditor is—  
2 “(I) an individual,  
3 “(II) an estate,  
4 “(III) a trust described in para-  
5 graph (2),  
6 “(IV) an exempt organization de-  
7 scribed in paragraph (6), or  
8 “(V) a person which is actively  
9 and regularly engaged in the business  
10 of lending money.”.

11 (b) EFFECTIVE DATE.—The amendment made by  
12 this section shall apply to taxable years beginning after  
13 December 31, 2003.

14 **SEC. 203. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**  
15 **COME AS A TERMINATION EVENT.**

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

18 (b) CONFORMING AMENDMENTS.—

19 (1) Section 1362(f)(1) is amended by striking  
20 “or (3)”.

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

1 (c) EFFECTIVE DATE.—The amendments made by  
2 this section shall apply to taxable years beginning after  
3 December 31, 2003.

4 **SEC. 204. MODIFICATIONS TO PASSIVE INCOME RULES.**

5 (a) INCREASED LIMIT.—

6 (1) IN GENERAL.—Subsection (a)(2) of section  
7 1375 (relating to tax imposed when passive invest-  
8 ment income of corporation having accumulated  
9 earnings and profits exceeds 25 percent of gross re-  
10 cepts) is amended by striking “25 percent” and in-  
11 serting “60 percent”.

12 (2) CONFORMING AMENDMENTS.—

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

16 (B) Clause (i) of section 1375(b)(1)(A) is  
17 amended by striking “25 percent” and inserting  
18 “60 percent”.

19 (C) The heading for section 1375 is  
20 amended by striking “**25 PERCENT**” and in-  
21 serting “**60 PERCENT**”.

22 (D) 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           (2) CONFORMING AMENDMENTS.—Section  
2           1375(d) is amended by striking “subchapter C” both  
3           places it appears and inserting “accumulated”.

4           (c) EFFECTIVE DATE.—The amendments made by  
5           this section shall apply to taxable years beginning after  
6           December 31, 2003.

7           **SEC. 205. ADJUSTMENT TO BASIS OF S CORPORATION**  
8                               **STOCK FOR CERTAIN CHARITABLE CON-**  
9                               **TRIBUTIONS.**

10          (a) IN GENERAL.—Paragraph (1) of section 1367(a)  
11          (relating to adjustments to basis of stock of shareholders,  
12          etc.) is amended by striking “and” at the end of subpara-  
13          graph (B), by striking the period at the end of subpara-  
14          graph (C) and inserting “, and”, and by adding at the  
15          end the following new subparagraph:

16                               “(D) the excess of the amount of the  
17                               shareholder’s proportionate share of any chari-  
18                               table contribution made by the S corporation  
19                               over the shareholder’s proportionate share of  
20                               the adjusted basis of the property contrib-  
21                               uted.”.

22          (b) EFFECTIVE DATE.—The amendments made by  
23          this section shall apply to taxable years beginning after  
24          December 31, 2003.

1       **TITLE III—TREATMENT OF S**  
2       **CORPORATION SHAREHOLDERS**

3       **SEC. 301. TREATMENT OF LOSSES TO SHAREHOLDERS.**

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

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

9               “(1) IN GENERAL.—The portion of any net loss  
10 recognized by a shareholder of an S corporation (as  
11 defined in section 1361(a)(1))—

12                       “(A) on amounts received by such share-  
13 holder in a distribution in complete liquidation  
14 of such S corporation, or

15                       “(B) on an installment obligation received  
16 by such shareholder with respect to a sale or  
17 exchange by the corporation during the 12-  
18 month period beginning on the date a plan of  
19 complete liquidation is adopted if the liquida-  
20 tion is completed during such 12-month period,  
21 which does not exceed the ordinary income basis of  
22 stock of such S corporation in the hands of such  
23 shareholder shall not be treated as a loss from the  
24 sale or exchange of a capital asset but shall be treat-  
25 ed as an ordinary loss.

1           “(2) ORDINARY INCOME BASIS.—For purposes  
2 of this subsection, the ordinary income basis of stock  
3 of an S corporation in the hands of a shareholder of  
4 such S corporation shall be an amount equal to the  
5 portion of such shareholder’s basis in such stock  
6 which is equal to the aggregate increases in such  
7 basis under section 1367(a)(1) resulting from such  
8 shareholder’s pro rata share of ordinary income of  
9 such S corporation attributable to the complete liq-  
10 uidation.”.

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

14           “(3) TREATMENT OF S YEAR AS ELAPSED  
15 YEAR; PASSIVE LOSSES.—Nothing in paragraphs (1)  
16 and (2) shall prevent treating a taxable year for  
17 which a corporation is an S corporation as a taxable  
18 year for purposes of determining the number of tax-  
19 able years to which an item may be carried back or  
20 carried forward nor prevent the allowance of a pas-  
21 sive activity loss deduction to the extent provided by  
22 section 469(g).”.

23           (c) EFFECTIVE DATE.—The amendments made by  
24 this section shall apply to taxable years beginning after  
25 December 31, 2003.

1 **SEC. 302. TRANSFER OF SUSPENDED LOSSES INCIDENT TO**  
 2 **DIVORCE.**

3 (a) IN GENERAL.—Section 1366(d) (relating to spe-  
 4 cial rules for losses and deductions) is amended by adding  
 5 at the end the following new paragraph:

6 “(4) TRANSFER OF SUSPENDED LOSSES AND  
 7 DEDUCTIONS WHEN STOCK IS TRANSFERRED INCI-  
 8 DENT TO DIVORCE.—For purposes of paragraph (2),  
 9 the transfer of any shareholder’s stock in an S cor-  
 10 poration incident to a decree of divorce shall include  
 11 any loss or deduction described in such paragraph  
 12 attributable to such stock.”.

13 (b) EFFECTIVE DATE.—The amendment made by  
 14 this section shall apply to transfers made after the date  
 15 of the enactment of this Act.

16 **SEC. 303. USE OF PASSIVE ACTIVITY LOSS AND AT-RISK**  
 17 **AMOUNTS BY QUALIFIED SUBCHAPTER S**  
 18 **TRUST INCOME BENEFICIARIES.**

19 (a) IN GENERAL.—Section 1361(d)(1) (relating to  
 20 special rule for qualified subchapter S trust) is amended—

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

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

25 (3) by adding at the end the following new sub-  
 26 paragraph:

1           “(C) for purposes of applying sections 465  
2           and 469(g) to the beneficiary of the trust, the  
3           disposition of the S corporation stock by the  
4           trust shall be treated as a disposition by such  
5           beneficiary.”.

6           (b) EFFECTIVE DATE.—The amendments made by  
7           this section shall apply to transfers made after the date  
8           of the enactment of this Act.

9   **SEC. 304. DEDUCTIBILITY OF INTEREST EXPENSE IN-**  
10                           **CURRED BY AN ELECTING SMALL BUSINESS**  
11                           **TRUST TO ACQUIRE S CORPORATION STOCK.**

12           (a) IN GENERAL.—Subparagraph (C) of section  
13           641(c)(2) (relating to modifications) is amended by insert-  
14           ing after clause (iii) the following new clause:

15                           “(iv) Any interest expense incurred to  
16                           acquire stock in an S corporation.”.

17           (b) EFFECTIVE DATE.—The amendment made by  
18           this section shall apply to taxable years beginning after  
19           December 31, 2003.

20   **SEC. 305. DISREGARD OF UNEXERCISED POWERS OF AP-**  
21                           **POINTMENT IN DETERMINING POTENTIAL**  
22                           **CURRENT BENEFICIARIES OF ESBT.**

23           (a) IN GENERAL.—Section 1361(e)(2) (defining po-  
24           tential current beneficiary) is amended—

1           (1) by inserting “(determined without regard to  
2           any unexercised (in whole or in part) power of ap-  
3           pointment during such period)” after “of the trust”  
4           in the first sentence, and

5           (2) by striking “60-day” in the second sentence  
6           and inserting “1-year”.

7           (b) EFFECTIVE DATE.—The amendments made by  
8           this section shall apply to taxable years beginning after  
9           December 31, 2003.

10 **SEC. 306. CLARIFICATION OF ELECTING SMALL BUSINESS**

11 **TRUST DISTRIBUTION RULES.**

12           (a) IN GENERAL.—Section 641(c)(1) (relating to spe-  
13           cial rules for taxation of electing small business trusts)  
14           is amended—

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

17           (2) by redesignating subparagraph (B) as sub-  
18           paragraph (C), and

19           (3) by inserting after subparagraph (A) the fol-  
20           lowing new subparagraph:

21           “(B) any distribution attributable to the  
22           portion treated as a separate trust shall be  
23           treated separately from any distribution attrib-  
24           utable to the portion not so treated, and”.

1 (b) EFFECTIVE DATE.—The amendments made by  
2 this section shall apply to taxable years beginning after  
3 December 31, 1996.

4 **SEC. 307. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**  
5 **DEDUCTION FOR ELECTING SMALL BUSINESS**  
6 **TRUSTS.**

7 (a) IN GENERAL.—Section 641(c)(2)(C) (relating to  
8 modifications), as amended by section 304(a), is amended  
9 by inserting after clause (iv) the following new clause:

10 “(v) Deductions described in section  
11 642(c)(1).”.

12 (b) CONFORMING AMENDMENT.—Section 512(e) (re-  
13 lating to special rules applicable to S corporations) is  
14 amended by redesignating subparagraph (3) as subpara-  
15 graph (4) and by inserting after subparagraph (2) the fol-  
16 lowing new subparagraph:

17 “(3) AMOUNTS RECEIVED FROM AN ELECTING  
18 SMALL BUSINESS TRUST.—Notwithstanding any  
19 other provision of this part, amounts received by an  
20 organization described in section 511(a)(2) from an  
21 electing small business trust (as defined in section  
22 1361(e)) shall be taken into account in computing  
23 the unrelated business taxable income of such orga-  
24 nization to the extent such amount is deducted by  
25 such trust under section 641(c)(2)(C)(v).”.

1 (c) EFFECTIVE DATE.—The amendments made by  
2 this section shall apply to taxable years beginning after  
3 December 31, 2003.

4 **SEC. 308. SHAREHOLDER BASIS NOT INCREASED BY IN-**  
5 **COME DERIVED FROM CANCELLATION OF S**  
6 **CORPORATION'S DEBT.**

7 (a) IN GENERAL.—Section 1366(a)(1) (relating to  
8 determination of shareholder's tax liability) is amended by  
9 inserting “but not including income excludable from gross  
10 income under section 108” after “tax-exempt income”.

11 (b) EFFECTIVE DATE.—The amendment made by  
12 this section shall apply to discharges of indebtedness oc-  
13 ccurring after December 31, 2002.

14 **SEC. 309. BACK TO BACK LOANS AS INDEBTEDNESS.**

15 (a) IN GENERAL.—Section 1366(d) (relating to spe-  
16 cial rules for losses and deductions) is amended by adding  
17 at the end the following new paragraph:

18 “(4) LOANS INCLUDED IN INDEBTEDNESS  
19 OF AN S CORPORATION.—For purposes of sub-  
20 section (d), the indebtedness of an S corpora-  
21 tion to the shareholder shall include any loans  
22 made or acquired (by purchase, gift, or dis-  
23 tribution from another person) by a shareholder  
24 to the S corporation, regardless of whether the  
25 funds loaned by the shareholder to the S cor-

1           poration were obtained by the shareholder by  
 2           means of a recourse loan from another person  
 3           (whether related or unrelated to the share-  
 4           holder).”.

5           (b) EFFECTIVE DATE.—The amendment made by  
 6 this section shall apply to taxable years beginning after  
 7 December 31, 2003.

8       **TITLE IV—EXPANSION OF S COR-**  
 9       **PORATION ELIGIBILITY FOR**  
 10      **BANKS**

11      **SEC. 401. EXCLUSION OF INVESTMENT SECURITIES INCOME**  
 12                           **FROM PASSIVE INCOME TEST FOR BANK S**  
 13                           **CORPORATIONS.**

14           (a) IN GENERAL.—Section 1375(b)(3) (defining pas-  
 15 sive investment income), as amended by section 204, is  
 16 amended by adding at the end the following new subpara-  
 17 graph:

18                           “(F) EXCEPTION FOR BANKS; ETC.—In  
 19 the case of a bank (as defined in section 581),  
 20 a bank holding company (as defined in section  
 21 246A(c)(3)(B)(ii)), or a qualified subchapter S  
 22 subsidiary which is a bank, the term ‘passive  
 23 investment income’ shall not include—

1           “(i) interest income earned by such  
2           bank, bank holding company, or qualified  
3           subchapter S subsidiary, or

4           “(ii) dividends on assets required to  
5           be held by such bank, bank holding com-  
6           pany, or qualified subchapter S subsidiary  
7           to conduct a banking business, including  
8           stock in the Federal Reserve Bank, the  
9           Federal Home Loan Bank, or the Federal  
10          Agricultural Mortgage Bank or participa-  
11          tion certificates issued by a Federal Inter-  
12          mediate Credit Bank.”.

13          (b) EFFECTIVE DATE.—The amendment made by  
14          this section shall apply to taxable years beginning after  
15          December 31, 1996.

16          **SEC. 402. TREATMENT OF QUALIFYING DIRECTOR SHARES.**

17          (a) IN GENERAL.—Section 1361 (defining S corpora-  
18          tion), as amended by section 201(a), is amended by adding  
19          at the end the following new subsection:

20                 “(g) TREATMENT OF QUALIFYING DIRECTOR  
21          SHARES.—

22                         “(1) IN GENERAL.—For purposes of this sub-  
23          chapter—

24                                 “(A) qualifying director shares shall not be  
25                                 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 qualifying director shares.

4           “(2) QUALIFYING DIRECTOR SHARES DE-  
5 FINED.—For purposes of this subsection, the term  
6 ‘qualifying director shares’ means any shares of  
7 stock in a bank (as defined in section 581) or in a  
8 bank holding company registered as such with the  
9 Federal Reserve System—

10           “(i) which are held by an individual  
11 solely by reason of status as a director of  
12 such bank or company or its controlled  
13 subsidiary; and

14           “(ii) which are subject to an agree-  
15 ment pursuant to which the holder is re-  
16 quired to dispose of the shares of stock  
17 upon termination of the holder’s status as  
18 a director at the same price as the indi-  
19 vidual acquired such shares of stock.

20           “(3) DISTRIBUTIONS.—A distribution (not in  
21 part or full payment in exchange for stock) made by  
22 the corporation with respect to qualifying director  
23 shares shall be includible as ordinary income of the  
24 holder and deductible to the corporation as an ex-

1       pense in computing taxable income under section  
2       1363(b) in the year such distribution is received.”.

3       (b) CONFORMING AMENDMENTS.—

4             (1) Section 1361(b)(1) is amended by inserting  
5       “, except as provided in subsection (g),” before  
6       “which does not”.

7             (2) Section 1366(a) is amended by adding at  
8       the end the following new paragraph:

9             “(3) ALLOCATION WITH RESPECT TO QUALI-  
10       FYING DIRECTOR SHARES.—The holders of quali-  
11       fying director shares (as defined in section 1361(g))  
12       shall not, with respect to such shares of stock, be al-  
13       located any of the items described in paragraph  
14       (1).”.

15            (3) Section 1373(a) is amended by striking  
16       “and” at the end of paragraph (1), by striking the  
17       period at the end of paragraph (2) and inserting  
18       “, and”, and adding at the end the following new  
19       paragraph:

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

23       (c) EFFECTIVE DATE.—The amendments made by  
24       this section shall apply to taxable years beginning after  
25       December 31, 1996.

1 **SEC. 403. RECAPTURE OF BAD DEBT RESERVES.**

2 Notwithstanding section 481 of the Internal Revenue  
 3 Code of 1986, with respect to any S corporation election  
 4 made by any bank in taxable years beginning after Decem-  
 5 ber 31, 1996, such bank may recognize built-in gains from  
 6 changing its accounting method for recognizing bad debts  
 7 from the reserve method under section 585 or 593 of such  
 8 Code to the charge-off method under section 166 of such  
 9 Code either in the taxable year ending with or beginning  
 10 with such an election.

11 **TITLE V—QUALIFIED**  
 12 **SUBCHAPTER S SUBSIDIARIES**

13 **SEC. 501. RELIEF FROM INADVERTENTLY INVALID QUALI-**  
 14 **FIED SUBCHAPTER S SUBSIDIARY ELECTIONS**  
 15 **AND TERMINATIONS.**

16 (a) IN GENERAL.—Section 1362(f) (relating to inad-  
 17 vertent invalid elections or terminations) is amended—

18 (1) by inserting “or under section  
 19 1361(b)(3)(B)(ii)” after “subsection (a)” in para-  
 20 graph (1),

21 (2) by inserting “or under section  
 22 1361(b)(3)(C)” after “subsection (d)” in paragraph  
 23 (1)(B),

24 (3) by inserting “or a qualified subchapter S  
 25 subsidiary, as the case may be” after “small busi-  
 26 ness corporation” in paragraph (3)(A),

1           (4) by inserting “or a qualified subchapter S  
2           subsidiary, as the case may be” after “S corpora-  
3           tion” in paragraph (4), and

4           (5) by inserting “or a qualified subchapter S  
5           subsidiary, as the case may be” after “S corpora-  
6           tion” in the matter following paragraph (4).

7           (b) EFFECTIVE DATE.—The amendments made by  
8           this section shall apply to taxable years beginning after  
9           December 31, 1996.

10 **SEC. 502. INFORMATION RETURNS FOR QUALIFIED SUB-**  
11 **CHAPTER S SUBSIDIARIES.**

12           (a) IN GENERAL.—Section 1361(b)(3)(A) (relating  
13           to treatment of certain wholly owned subsidiaries) is  
14           amended by inserting “and in the case of information re-  
15           turns required under part III of subchapter A of chapter  
16           61” after “Secretary”.

17           (b) EFFECTIVE DATE.—The amendment made by  
18           this section shall apply to taxable years beginning after  
19           December 31, 2003.

20 **SEC. 503. TREATMENT OF THE SALE OF INTEREST IN A**  
21 **QUALIFIED SUBCHAPTER S SUBSIDIARY.**

22           (a) IN GENERAL.—Section 1361(b)(3) (relating to  
23           treatment of certain wholly owned subsidiaries) is amend-  
24           ed by adding at the end the following new subparagraph:

1           “(E) SPECIAL RULE ON TERMINATION.—  
2           The tax treatment of the disposition of the  
3           stock of the qualified subchapter S subsidiary  
4           shall be determined as if such disposition  
5           were—

6                   “(i) a sale of the undivided interest in  
7                   the subsidiary’s assets based on the per-  
8                   centage of the stock transferred, and

9                   “(ii) followed by a deemed contribu-  
10                  tion by the S corporation and the trans-  
11                  feree in a section 351 transaction.”.

12          (b) EFFECTIVE DATE.—The amendment made by  
13 this section shall apply to taxable years beginning after  
14 December 31, 1996.

15 **SEC. 504. EXCEPTION TO APPLICATION OF STEP TRANS-**  
16 **ACTION DOCTRINE FOR RESTRUCTURING IN**  
17 **CONNECTION WITH MAKING QUALIFIED SUB-**  
18 **CHAPTER S SUBSIDIARY ELECTIONS.**

19          (a) IN GENERAL.—Section 1361(b)(3) (relating to  
20 treatment of certain wholly owned subsidiaries), as amend-  
21 ed by section 503, is amended by redesignating subpara-  
22 graphs (C), (D), and (E), as subparagraphs (D), (E), and  
23 (F), respectively, and by inserting after subparagraph (B)  
24 the following new subparagraph:

1           “(C) TREATMENT OF ELECTION.—The  
2           election under subparagraph (B)(ii) shall be  
3           treated as a liquidation of the qualified sub-  
4           chapter S subsidiary to which section 332 ap-  
5           plies.”.

6           (b) EFFECTIVE DATE.—The amendments made by  
7           this section shall apply to elections effective after Decem-  
8           ber 31, 2003.

9                           **TITLE VI—ADDITIONAL**  
10                           **PROVISIONS**

11           **SEC. 601. ELIMINATION OF ALL EARNINGS AND PROFITS**  
12                           **ATTRIBUTABLE TO PRE-1983 YEARS.**

13           (a) IN GENERAL.—Subsection (a) of section 1311 of  
14           the Small Business Job Protection Act of 1996 is amend-  
15           ed to read as follows:

16           “(a) IN GENERAL.—If a corporation was an electing  
17           small business corporation under subchapter S of chapter  
18           1 of the Internal Revenue Code of 1986 for any taxable  
19           year beginning before January 1, 1983, the amount of  
20           such corporation’s accumulated earnings and profits (as  
21           of the beginning of any taxable year beginning after De-  
22           cember 31, 1982) shall be reduced by an amount equal  
23           to the portion (if any) of such accumulated earnings and  
24           profits which were accumulated in any taxable year begin-  
25           ning before January 1, 1983, for which such corporation

1 was an electing small business corporation under such  
2 subchapter S.”.

3 (b) EFFECTIVE DATE.—The amendment made by  
4 this section shall apply to taxable years beginning after  
5 December 31, 1996.

6 **SEC. 602. NO GAIN OR LOSS ON DEFERRED INTERCOMPANY**  
7 **TRANSACTIONS BECAUSE OF CONVERSION**  
8 **TO S CORPORATION OR QUALIFIED S COR-**  
9 **PORATION SUBSIDIARY.**

10 With respect to taxable years beginning before, on,  
11 or after July 12, 1995, the regulations under section 1502  
12 of the Internal Revenue Code of 1986 shall not cause gain  
13 or loss to be recognized by reason of an election under  
14 section 1361(b)(3)(B) or 1362(a) of such Code.

15 **SEC. 603. TREATMENT OF CHARITABLE CONTRIBUTION**  
16 **AND FOREIGN TAX CREDIT**  
17 **CARRYFORWARDS.**

18 (a) CHARITABLE CONTRIBUTION  
19 CARRYFORWARDS.—The last sentence of section  
20 1374(b)(2) (relating to net operating loss carryforwards  
21 from C years allowed) is amended by inserting “or a chari-  
22 table contribution carryforward under section 170(d)(2)”  
23 after “capital loss carryforward”.

24 (b) FOREIGN TAX CREDIT CARRYFORWARDS.—The  
25 last sentence of section 1374(b)(3)(B) (relating to busi-

1 ness credit carryforwards from C years allowed) is amend-  
2 ed by inserting “and the foreign tax credit carryforward  
3 under section 904” after “section 53”.

4 (c) TREATMENT OF ADDITIONAL  
5 CARRYFORWARDS.—Section 1374(b) (relating to amount  
6 of tax) is amended by adding at the end the following new  
7 paragraph:

8 “(5) TREATMENT OF ADDITIONAL  
9 CARRYFORWARDS.—The Secretary under regulations  
10 shall provide treatment similar to the preceding  
11 paragraphs of this subsection for other  
12 carryforwards attributable to taxable years for which  
13 an S corporation was a C corporation.”.

14 (d) EFFECTIVE DATE.—The amendments made by  
15 this section shall apply to taxable years beginning after  
16 December 31, 2003.

17 **SEC. 604. DISTRIBUTIONS BY AN S CORPORATION TO AN**  
18 **EMPLOYEE STOCK OWNERSHIP PLAN.**

19 (a) IN GENERAL.—Section 1368 (relating to distribu-  
20 tions) is amended by adding at the end the following new  
21 subsection:

22 “(f) DISTRIBUTIONS BY AN S CORPORATION TO AN  
23 EMPLOYEE STOCK OWNERSHIP PLAN.—Any distribution  
24 described in subsection (a) to an employee stock ownership

1 plan (as defined in section 4975(e)(7)) shall be treated  
2 as a dividend under section 404(k)(2)(A).”.

3 (b) TECHNICAL AMENDMENT.—Section 404(a)(9)(C)  
4 (relating to S corporations) is amended to read as follows:

5 “(C) S CORPORATIONS.—The deduction  
6 provided in this paragraph shall not apply to an  
7 S corporation.”.

8 (c) EFFECTIVE DATE.—The amendments made by  
9 this section shall apply to distributions received after the  
10 date of the enactment of this Act.

11 **SEC. 605. SPECIAL RULES OF APPLICATION.**

12 (a) WAIVER OF LIMITATIONS.—If refund or credit of  
13 any overpayment of tax resulting from the application of  
14 any amendment made by this Act is prevented at any time  
15 before the close of the 1-year period beginning on the date  
16 of the enactment of this Act by the operation of any law  
17 or rule of law (including res judicata), such refund or cred-  
18 it may nevertheless be made or allowed if claimed therefor  
19 is filed before the close of such period.

20 (b) TREATMENT OF CERTAIN ELECTIONS UNDER  
21 PRIOR LAW.—For purposes of section 1362(g) of the In-  
22 ternal Revenue Code of 1986 (relating to election after  
23 termination), any termination or revocation under section

1 1362(d) of such Code (as in effect on the day before enact-  
2 ment of this Act) shall not be taken into account.

○