



S-CORP

**THE S CORPORATION ASSOCIATION
OF AMERICA**

“Defending America’s Small and Family-Owned Businesses”

**Statement of Rick L. Klahsen
for the
S Corporation Association**

**House Committee on Small Business Subcommittee on Finance and Tax
“S-corps: Recommended Reforms that Promote Parity, Growth and
Development for Small Businesses”**

June 18, 2008

Chairwoman Bean, Ranking Member Buchanan and other members of the Subcommittee, thank you for the opportunity to testify today.

My name is Rick Klahsen. I am a Managing Director in the National Tax department of RSM McGladrey, Inc., and the National Service Line Leader for Tax Advisory & Compliance.

RSM McGladrey, when combined with McGladrey & Pullen, is the fifth largest business consulting, accounting, and tax firm that focuses on mid-sized companies. With over 100 offices nationwide, we offer business and tax consulting, wealth management, retirement resources, payroll services and corporate finance to our clients.

I also serve on the Board of Advisors for the S Corporation Association and submit my testimony today on its behalf. The S Corporation Association is the only organization in Washington D.C. exclusively devoted to promoting and protecting the interests of America’s 4.2 million S corporation owners. The Association focuses on ensuring that America’s most popular corporate structure remains competitive in the Twenty-First Century.

I want to thank you for holding this hearing to consider reforms that would promote equality and development for S Corporations. It is especially fitting given that this year the S corporation celebrates its 50th birthday.

History of the S Corporation

Before Congress created S corporations, entrepreneurs had two basic choices when starting a business. They could form a regular C corporation, and enjoy liability protection but face two layers of federal tax at the corporate and individual level. Or they could form a partnership or

operate as a sole proprietorship, and enjoy a single layer of taxation at the individual level but sacrifice the umbrella of liability protection.

Neither choice was optimal for small and family-owned businesses. In 1946, the Department of Treasury suggested a third option—merging a single layer of federal tax with comprehensive liability protection. President Dwight Eisenhower joined the cause, and promoted the passage of legislation to encourage small business growth and entrepreneurship.

In 1958, Congress acted on President Eisenhower's recommendation, creating subchapter S of the tax code. In exchange for enjoying a single layer of tax, entrepreneurs electing S corporation status agreed to the following limitations:

- They were required to be a domestic enterprise;
- They were required to have a limited number of shareholders;
- They were limited by who those shareholders could be; and
- They could have just one class of stock.

How significant was the creation of subchapter S? Consider that in 1958, the top income tax rate was 52 percent for corporations and 91 percent for individuals. Dividends paid by a C corporation to a high-income shareholder faced an effective tax rate of 96 percent! Even a shareholder with median family income faced an effective federal tax of more than 60 percent. Creation of the S corporation was a huge step forward in eliminating a devastating double tax and encouraging small and family business creation in the United States.

Nearly a half century later, S corporations are the most popular corporate structure in America, with twice as many firms as C corporations.

Growth of Pass-Through Businesses

An important trend over the past three decades is the dramatic growth in the number of S corporations and partnerships, including limited liability companies.

The number of S corporation returns has increased from less than 500,000 in 1978 to more than 4 million today. Partnerships have seen similar growth, increasing from 1.2 million in 1978 to about 3 million today.

At the same time, the number of regular C corporations peaked in 1986 at 2.6 million and has declined steadily since then. The overall contribution of C corporations to tax receipts is declining as well. When S corporations were created in 1958, C corporations paid a quarter of all federal tax receipts. In the last five years, their contribution has ranged between 7 and 15 percent.

The growth of pass-through businesses coupled with the decline of the traditional C corporation has had the effect of shifting an increasing amount of business income from the corporate tax code to the individual tax code.

This means that tax policy for businesses is increasingly affected by changes to the individual tax code. As Treasury reported earlier this year, more than a third of those taxpayers paying taxes in the top two rates have business income that exceeds 30 percent of their total income. Much of this income can be attributed to partnerships and S corporations. We believe policymakers in Washington need to be acutely aware of the dynamic between individual tax rates and business income as they consider broad-based tax reform.

S Corporation Reform

The history of S corporations, the growth of limited liability companies as a competing business structure, and the need to update rules dating back five decades all combine to make S corporation reform an important part of any effort to update the tax code. Over the years, the S Corporation Association has worked with policymakers in Congress as well as allied trade associations to develop a list of critical reforms Congress should consider. These reforms include:

Built-In Gains Tax Relief: Businesses converting to S corporation must hold on to any appreciated assets for 10 years following their conversion or face a business level tax imposed on the built-in gain at the highest corporate rate of 35 percent. We support decreasing the holding period of assets subject to the built-in gains tax from 10 years to 7 years.

Repeal of excessive passive investment income as a termination event: We support repealing the rule that an S corporation would lose its S corporation status if it has excess passive income for three consecutive years.

Modifications to passive income rules: We support increasing the threshold for taxing excess passive income from 25 percent to 60 percent (consistent with a Joint Tax Committee recommendation on simplification measures). In addition, we advocate removing gains from the sales or exchanges of stock or securities from the definition of passive investment income for purposes of the sting tax.

Nonresident Aliens as Shareholders: We support permitting nonresident aliens to be S corporation shareholders. To assure collection of the appropriate amount of tax, we would like to require S corporations to withhold and pay a tax on effectively connected income allocable to its nonresident alien shareholders. Additionally, we advocate enhancing an S corporation's ability to expand into international markets and expanding an S corporation's access to capital.

IRAs as Shareholders: Congress has previously allowed IRAs to hold stock in a bank that is an S corporation "only to the extent of bank stock held by the IRA on the date of enactment." We support extending this provision to allow IRAs to hold stock in all S corporations.

Permit Issuance of Preferred Stock: We support permitting S corporations to issue qualified preferred stock. To qualify, the stock would not be entitled to vote, would be

limited and preferred as to dividends, would not participate in corporate growth to any significant extent, and would have redemption and liquidation rights which do not exceed the issue price of such stock. This reform increases access to capital from investors who insist on having a preferential return and facilitates family succession by permitting the older generation of shareholders to relinquish control of the corporation but maintain an equity interest.

Safe Harbor Expanded to Include Convertible Debt: We support permitting S corporations to issue debt that may be converted into stock of the corporation provided that the terms of the debt are substantially the same as the terms that could have been obtained from an unrelated party. This reform would also expand the current law safe harbor debt provision to permit nonresident aliens as creditors.

S Corporation Certainty: We support providing reasonable certainty to S-corporations and their shareholders as to the entity's tax status as an S corporation by adding language to Section 1362(f) that would allow an S corporation, without IRS consent, to rectify an ineffective election or a terminating event, if such event occurred in a year in which the statute of limitations for claiming a credit or refund has expired. As long as the S corporation corrects the item and its shareholders report information consistent with S corporation rules in all years for which a claim for credit or refund has not expired, the corporation's status as an S corporation will be respected.

In this Congress, the S Corporation Association has been fortunate to enjoy the support of senior members of both the Ways and Means Committee in the House and the Finance Committee in the Senate. Legislation introduced in both bodies would advance the rules governing S corporations dramatically. These legislative initiatives include:

S Corporation Modernization Act of 2007: Introduced by Ways and Means members Congressmen Ron Kind (D-WI) and Jim Ramstad (R-MN) on December 19, 2007, the "S Corporation Modernization Act" is designed to simplify the rules under which S corporations operate. Original cosponsors of [H.R. 4840](#) represent Districts across the country, including Representatives Stephanie Tubbs-Jones (D-OH), Phil English (R-PA), Allyson Schwartz (D-PA), Sam Johnson (R-TX), and Steve Kagen (D-WI).

The bill is endorsed by an impressive group of business associations and includes reforms important to keeping S corporations competitive both here at home and abroad, including:

- Modernizing the rules that apply to firms that have selected S corporation status;
- Increasing the ability of S corporations to access needed capital; and
- Encouraging S corporations to support charity through small business trusts.

With the number of Ways and Means members supporting these important reforms, we are hopeful that Congress will take up this legislation this year.

Small Business Growth and Opportunity Act: The "Small Business Growth and

Opportunity Act” was introduced by Congressman Steve Kagen (D-WI) and Ways and Means members Congressmen Jim Ramstad (R-MN), Ron Kind (D-WI) and Phil English (R-PA) on October 17, 2007.

The bill would reduce from ten to seven years the period that a business must hold onto appreciated property before it can be sold. Under current rules, S corporations that sell their appreciated assets prior to the 10-year waiting period are subject to the punitive built-in gains tax.

Other [H.R. 3874](#) cosponsors include representatives from across the country, including Congressmen Richard Baker (R-LA), Jerry McNerney (D-CA), Michael Conaway (R-TX) and House Financial Services Committee member Congressman Dennis Moore (D-KS).

S Corporation Modernization Act of 2008: Introduced by Finance Members and long time S corporation champions Senator Blanche Lincoln (D-AR) and Orin Hatch (R-UT) on May 23, 2008, “The S Corporation Modernization Act of 2008 ” is the companion bill to H.R. 4840 and is designed to simplify the rules under which S corporations operate. Current cosponsors of S. 3063 include Senators Ben Cardin (D-MD), Gordon Smith (R-OR) and Olympia Snowe (R-ME).

Like H.R. 4840, the bill has been [endorsed](#) by an impressive group of business associations and the S Corporation Association has great expectations that the provisions of S. 3063 will become law in the near future.

S Corporations and Economic Stimulus

Another area where S corporation reform can help is with capital investment and economic growth. As Congress examines what provisions should be included in a possible second stimulus package, we believe policymakers should consider relief from the built-in gains tax (BIG) as a means of freeing up much needed capital.

BIG applies to any appreciated assets that are held by a firm converting to S corporation. Under BIG, these firms are required to hold these assets for at least ten years or be subject to a punitive level of tax—first the BIG corporate tax rate of 35 percent and then all the other applicable federal, state and local tax rates.

According to government statistics, hundreds of thousands of S corporations nationwide may be sitting on “locked-up” capital that they cannot access or redeploy due to the prohibitive tax implications of BIG. This “lock-in effect” is widespread and results in these businesses being unable to access billions of dollars in assets that could be used to grow the business and hire new employees.

The inability to access this capital is particularly harmful to S corporations. As closely-held businesses with limited access to the public markets, they have fewer options for raising capital than many of their competitors.

In an economy where a one or two percent change in growth can mean the difference between a recession and moderate growth, eliminating that lock-in effect and allowing those assets to become fully productive could be significant.

C Corp Rate Reduction and S Corporations

Another potential challenge to the S corporation community is the proposed reduction in the tax rate applying to C corporations. While this proposal is pro-growth and a benefit to the entire American economy, the manner in which it is carried out may have significant adverse effects on pass-through businesses.

In the past year, both the Secretary of Treasury and the Chairman of the House Ways and Means Committee have proposed to reduce the tax rate on C corporations while eliminating certain tax benefits that they currently enjoy, including the recently enacted Section 199 deduction, LIFO accounting rules and other targeted tax benefits.

The overall goal of the two proposals was to reduce marginal tax rates on corporations while broadening the tax base. With the federal tax on corporate income the second highest in the world, reducing the tax would significantly increase the ability of U.S. corporations to compete in global markets.

The challenge for the Treasury and the Ways and Means Committee is that many of the businesses that use Section 199 and the other business tax benefits eliminated as part of the base broadening are not C corporations. In other words, the effort to cut the marginal tax on C corporations would have also significantly raised taxes on S corporations and partnerships.

The S Corporation Association has met with the tax staffs at Treasury and the Ways and Means Committee to discuss this adverse outcome for pass-through businesses and we believe this is an appropriate issue for the Small Business Committee to take on as Congress considers major reforms to the tax code next year. Lower rates for C corporations would likely benefit the economy and job creation, but only if these reductions do not come at the expense of S corporations and partnerships.

S Corporations and the Payroll Tax

A final important issue to the S corporation community is how to appropriately tax income earned by S corporation shareholders who actively work at their business.

When Congress created the S corporation in 1958, the IRS ruled that only S corporation shareholders who are active in their business should be subject to payroll taxes only on amounts received for their labor. While the payroll tax has grown dramatically in the past fifty years, the application of payroll taxes has always applied to labor income, not capital income. In recent years, however, several proposals have been put forward that would alter this historic relationship and increase the application of payroll taxes on S corporations.

In January of 2005, the Joint Committee on Taxation (JCT) recommended that Congress apply payroll taxes to all S corporation income where the shareholder works at the business as part of a broader set of proposals to raise revenue. The JCT estimated its proposal would raise \$57.4 billion over ten years.

In May of 2005, the Treasury Inspector General for Tax Administration (TIGTA) issued a memorandum recommending a similar payroll tax increase on S corporations, arguing that all income from S corporations more than 50 percent owned by a single shareholder should be subject to payroll taxes.

More recently, the JCT modified its original proposal so that it would apply payroll taxes to S corporation income where the S corporation is a service business. While more targeted than their original proposal, this JCT proposal suffers from similar flaws. It changes the nature of payroll taxes and raises taxes on small and mid-sized businesses.

Finally, in October of 2007, Ways and Means Chairman Charles Rangel introduced legislation that, among other items, would impose payroll taxes funding Social Security and Medicare on S corporations with service-related income. Under the bill, the tax increase would be limited to the income from service business only. Under the Rangel bill, S corporations with income primarily from the service sector of the economy would see payroll taxes applied to the entirety of their service income, rather than just the portion paid out as wages.

The S Corporation Association appreciates the concern that certain taxpayers are paying less than their fair share of payroll taxes. However, the IRS already has the tools necessary to identify these taxpayers and force them to pay the correct level of tax. While applying these tools may be time-intensive and costly, alternative proposals risk raising payroll taxes on small and family-owned businesses that are fully complying with the law and paying all the taxes they owe.

Getting the solution to this challenge right is important, and the S Corporation Association looks forward to working with the Ways and Means and Small Business Committees to ensure whatever reform is enacted does not adversely impact law-abiding business owners.

Conclusion

Chairwoman Bean, the S Corporation Association and I greatly appreciate the opportunity to testify today and to highlight various issues of concern to the S corporation community. I thank you for this opportunity and I am happy to answer any questions you may have.