Testimony

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Subcommittee on Finance and Tax
United States House of Representatives

S-corps: Recommended Reforms that Promote Parity, Growth and Development for Small Business

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I. Introduction

Good morning. Madam Chair, Ranking Member Buchanan, and members of the subcommittee, I am Kevin Anderson, a partner of BDO Seidman, LLP, a firm that provides tax, audit, financial advisory, and consulting services to clients across the country. I am pleased to have this opportunity to present my views on potential S corporation reform and expansion. I wish to emphasize that I am here to offer my own personal views based on many years of accounting, law firm, and government experience in this area, and not to advance the interests of any particular client or those of my firm.

The other panel members have adequately covered proposed legislative changes in the S corporation area that would, if enacted, promote the goals of parity, growth, and development. I will generally refrain from supporting or opposing any of the specific proposals discussed by the other panelists. Instead, in the time that I have, I would like to address some of the policies that have motivated the development of the S corporation form in the 50 years since its origin. I will then discuss some of the policy considerations that might govern the analysis of the proposals being discussed here.

II. The S Corporation—Straddling Two Worlds

The S corporation has always had some features in common with both partnerships and C corporations. Partnerships are always taxed only once on their income, while C corporations incur potential double taxation on distributed profits and are also subject to a variety of other tax provisions unique to corporations. Like a partnership, an S corporation is generally not taxed directly on its income, but its shareholders are required to include their share of the income in their own returns, and may deduct their share of the losses of the corporation, subject to applicable limitations.[1] When an S corporation makes distributions to its shareholders, the income is not taxed a second time, but the distribution is considered as a return or recovery of the shareholders' previously taxed profits.

On the other hand, a C corporation is directly subject to tax on its profits, while its losses may only be used to offset its own income or the income of other members of a group of corporations with which it files a consolidated

[1] IRC Sections 1366 through 1368 set forth the general "flow-through" rules applicable to S corporations and their shareholders.

return. A corporation may be organized and reorganized under provisions of subchapter C of the Internal Revenue Code that apply only to corporations. Similarly, a corporation may be recapitalized, divided, liquidated, purchased, or sold under provisions uniquely applicable to corporations. Like a C corporation, an S corporation is subject to most of these subchapter C provisions for its extraordinary transactions.[2]

Because an S corporation has income tax features that are common to both partnerships and taxable corporations, it is sometimes difficult to determine whether a particular provision should be modified to bring the treatment of S corporations closer to that of partnerships or to that of other corporations. I submit that some of the proposals being discussed today would, if enacted, bring the S corporation more in line with C corporations, while other proposals would bring S corporations closer to partnerships. There is little that these proposals have in common other than that they make the S corporation form more widely available and more tax efficient.

III. Policy Considerations for Further Reform and Expansion

To the extent that parity is a goal of S corporation reform, it is therefore appropriate to ask whether parity is an achievable goal and, if it is, parity with what? Do we seek parity with the tax treatment of business income generally, regardless of the type of entity employed? Parity with partnerships? Parity with C corporations? Parity with the taxation of individuals? In view of the scheduled expiration of the individual income tax rate reductions after 2010, and the proposals of the major-party presidential candidates for modifications to the individual and/or corporate tax rates, the question of parity will loom ever larger.

It is also appropriate to recognize that changes to reduce the level of taxation of S corporation income, or to make S corporation status more readily available, will have revenue implications. When the Joint Committee on Taxation scored the S corporation expansion and relief provisions that were enacted in 1996,[3] 2004,[4] and 2007,[5] these provisions were estimated to

[2] IRC Section 1371(a) provides that, except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, the provisions of subchapter C shall apply to an S corporation and its shareholders.
[3] Small Business Job Protection Act of 1996, Pub. L. No. 104-188.
[4] American Jobs Creation Act of 2004, Pub. L. No. 108-357.
[5] Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28.

reduce revenues over the applicable window. I expect that the same would be true of many of the provisions being advocated here today.

Despite recent increases in the number of permissible shareholders of an S corporation, the policies underlying the statutory structure of S corporation taxation have been grounded in a desire for simplicity. The most obvious means that Congress has used to date in order to achieve simplicity is the single-class-of-stock requirement for S corporations.[6] Under this requirement, although differences in voting rights among various classes of stock are permitted, all outstanding shares must have the same "economic" rights, *i.e.*, the rights to regular distributions and liquidation proceeds.[7] At the end of the year, the profits and losses are allocated to shareholders simply on the basis of the number of shares owned by each shareholder, with adjustments only for those shareholders whose stock interests varied throughout the year.[8]

Shareholder limitations—both quantitative and qualitative—also promote the objective of keeping S corporations small. After all, the Internal Revenue Code refers to them as "small business corporations."[9] However, there is no limitation on the size of an S corporation based on revenues, assets, profits, employees, or similar measures. Indeed, even with the current limitations, there are a few S corporation banks or bank holding companies with several billions of dollars of assets.[10] Measures that increase the number and type of permitted shareholders will inevitably result in further increases in the size of S corporations. As the size of S corporations increases, complexity may also increase.

There are also provisions to ensure that S corporation income is taxed currently to its shareholders, without significant potential for deferral. This policy forms the basis for applying the unrelated business income tax to tax-

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[6] IRC Section 1361(b)(1)(D).

[7] IRC Section 1361(c)(4); Treas. Reg. § 1.1361-1(*l*)(2)(i).

[8] IRC Section 1377(a)(1). In certain cases, the corporation and the affected shareholders are permitted to treat the two parts of the taxable year, *i.e.,* the portion preceding and the portion following the change in ownership of S corporation stock, as if it were two separate taxable years. Under this "closing of the books" election, the income or loss is allocated to the pre-change portion of the taxable year using the stock ownership during that period, and the income or loss is allocated to the post-change portion of the taxable year using the stock ownership during that period.

[9] IRC Section 1361(b)(1).

[10] Publicly-available information obtained from the Web site of the Federal Deposit Insurance Corporation (www.fdic.gov) indicates that, as of March 31, 2008, two S corporation banks had assets in excess of $10 billion each.

exempt shareholders, such as pension and profit-sharing plans, charitable organizations, and the small number of individual retirement accounts that currently are permitted to be shareholders.[11] The only exception to this rule exists for employee stock ownership plans, or ESOPs, that own stock in an S corporation.[12]

Finally, the built-in gains provisions, which currently require a ten-year holding period after conversion from C corporation to S corporation status, are the product of a fundamental decision that Congress made with the Tax Reform Act of 1986.[13] The repeal of the so-called *General Utilities* doctrine[14] solidified the policy decision to subject to tax all appreciation on assets held by C corporations regardless of how the asset is disposed of. Thus, whether an asset is sold to a third party, distributed to its shareholders as a dividend, or distributed to its shareholders in liquidation of the corporation, the corporation must recognize the gain as if the property had been sold for its fair market value.[15] In order to prevent S corporations from being used as a means to circumvent the repeal of the *General Utilities* doctrine, the built-in gains provisions impose a corporate level-tax on S corporations in much the same manner as a C corporation would be taxed.

IV. Specific Proposals

The proposals under consideration fare somewhat differently when compared measured against some of these historical policies. I hope to provide a few comments on some of the more frequently-considered provisions, again without either supporting or opposing them.

A. Increase in the Shareholder Limitations

An increase in the shareholder limitations from 100 to 150—the number most frequently used in current proposals—would increase the size and complexity of S corporations at the margins.[16] The current-law treatment of

[11] IRC Section 512(e).
[12] IRC Section 512(e)(3).
[13] IRC Section 1374 (generally) and Section 1374(d)(7) (regarding definition of recognition period).
[14] The doctrine is named for the Supreme Court decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).
[15] IRC Sections 311(b) and 336(a).
[16] Despite prior increases in the number of permitted shareholders of an S corporation, the vast majority of S corporations have relatively few shareholders. The most recent IRS Statistics of Income (Spring 2008), based on 2003 tax returns (available at www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html), indicates that more than 99 percent of S corporations have ten or fewer shareholders.

family members as if they are one individual applies only for counting and qualification purposes.[17] Thus, an S corporation may currently have, for example, 200 shareholders to whom income must be allocated. The ability to have large numbers of shareholders imposes significant compliance burdens on S corporations, especially if the corporation has operations in several states. More to the point, if the Internal Revenue Service were to examine the S corporation return and adjust the income or loss of the corporation, the Service must also proceed against all 200 shareholders to collect any additional tax and interest. An increase in the number of shareholders could exacerbate the examination and collection issues that are currently faced by the Service.[18]

B. Permit Nonresident Aliens to be Shareholders

Because the Internal Revenue Code imposes a tax on the worldwide income of United States citizens and residents, the nonresident alien is the only category of individual on whom worldwide taxation is not imposed. Instead, the nonresident alien is taxed only on income that is considered to have a United States source. Historically, nonresident aliens have not been permitted to be shareholders in an S corporation because of the perceived difficulty of collecting taxes that would be imposed on their shares of S corporation income.[19] Any proposal that would permit such individuals as S corporation shareholders would have to address the requirements for collecting tax, and would most likely include a complex withholding regime and other filing requirements.[20]

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[17] IRC Section 1361(c)(1).

[18] Congress had previously extended so-called "TEFRA" partnership provisions to S corporations. These provisions require most examinations to be resolved at the entity level rather than at the owner level. The partnership TEFRA provisions are set forth in IRC Sections 6221 through 6234. The S corporation provisions, which were set forth in former IRC Sections 6241 through 6245, were repealed by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Section 1307(c)(1), and replaced with an obligation of consistency of treatment between the S corporation shareholder and its shareholders. *See* IRC Section 6037(c). If the shareholder does not report a "subchapter S item" consistently with the corporation's reporting of the same item, the Service must be notified of the inconsistency.

[19] IRC Section 1361(b)(1)(C) defines a "small business corporation" as a domestic corporation that does not have a nonresident alien as a shareholder.

[20] IRC Section 1446 requires a partnership to withhold tax on effectively connected taxable income allocable to a foreign partner. A comparable provision should be enacted if S corporations are permitted to have nonresident aliens as shareholders.

C. Permit Individual Retirement Accounts to Own S Corporation Stock

The limited provision under current law which permits certain individual retirement accounts to own stock in S corporation banks or bank holding companies is already coupled with a requirement that ensures current taxation of S corporation income.[21] An IRA holding stock in an S corporation must pay the unrelated business income tax, or UBIT, on its allocated share of S corporation income. In my experience, it is extremely unusual for an IRA to incur and pay a UBIT, and a wholesale expansion of S corporation availability for IRAs would also greatly increase the compliance burdens on such accounts and their custodians and beneficiaries.

D. Allow S Corporations to Issue Preferred Stock

The proposal to permit S corporations to issue preferred stock would most certainly increase their access to certain capital markets. There are clearly certain types of investors that will insist upon having a preferred claim against the assets of the corporation. Having provided the most recent capital needed to permit a corporation to survive or grow, such investors may not wish to place their capital at the same risk as that of the common stockholders. However, such investors may also desire to obtain some of the "upside" potential that is accorded to the holders of common stock. The desire to invest in preferred stock, convertible debt, or debt with detachable warrants is often driven by business considerations rather than by tax considerations. Under current law, the use of preferred stock is absolutely prohibited for S corporations,[22] while the use of debt with certain equity-like features raises questions about the single-class-of-stock requirements.[23]

As indicated above, the historical basis for the single-class-of-stock requirement is the need to make simple allocations of S corporation income or loss. In order to preserve this goal, the proposals under consideration would give preferred stock certain debt-like characteristics. That is, distributions on preferred stock would be treated as an expense of the corporation, and only the net income or loss remaining after deducting such

[21] IRC Section 1361(c)(2)(A)(vi) permits IRAs to be shareholders of an S corporation, subject to significant restrictions and limitations, and IRC Section 512(e)(1) specifically imposes the unrelated business income tax on an IRA that is permitted to hold stock in an S corporation.
[22] IRC Section 1361(b)(1)(D).
[23] IRC Section 1361(c)(5) (straight-debt safe harbor not available for convertible debt); Treas. Reg. § 1.1361-1(*l*)(4) (certain instruments, obligations, or arrangements treated as a second class of stock).

dividends would be allocated to holders of the common stock on a per-share basis. This approach is currently being used for "restricted bank director stock" issued by banks and bank holding companies,[24] and a further expansion of this approach would add even more complexity to subchapter S. Moreover, the Code tends to draw a careful line between the treatment of debt, on the one hand, and equity on the other. Such a proposal would further blur the distinction between debt and equity for tax purposes.

E. Decrease the Built-in Gains Tax Holding Period

As I indicated above, the built-in gains tax was originally imposed to prevent C corporations from converting to S corporation status and quickly making post-conversion sales of appreciated property, thus circumventing the repeal of the *General Utilities* doctrine. An S corporation was not permanently subject to this tax, but only if it sold an appreciated asset within ten years after converting from C corporation status.[25] Candidly, the ten-year period was arbitrary, no more or less so than the seven-year period being advocated by these proposals. A reduction of the recognition period from ten to seven years will necessarily have revenue implications, as it will permit S corporations to sell assets in the eighth, ninth, or tenth years of S corporation status without the imposition of a corporate-level tax.

As a footnote to this discussion, the Service has used the ten-year recognition period as a model for other situations in which a C corporation converts to a flow-through entity, such as a regulated investment company (mutual fund) or real estate investment trust.[26] Thus, a change in the S corporation recognition period will likely have implications for these other types of flow-through entities as well.

F. Increase Passive Investment Income Threshold from 25 Percent to 60 Percent

The origins of the section 1375 tax on excess net passive income are somewhat obscure. This tax applies only to those S corporations that have

[24] IRC Section 1361(f) provides that such stock is not taken into account as a class of outstanding stock for purposes of subchapter S, while IRC Section 1368(f) provides rules for the tax treatment of distributions with respect to such stock.
[25] IRC Section 1374(d)(7) defines the recognition period during which the tax is imposed as the ten-year period beginning with the first day of the first taxable year for which the corporation is an S corporation.
[26] Treas. Reg. § 1.337(d)-7(b).

"earnings and profits" accumulated in C corporation years.[27] Some have speculated that the tax deters the use of converted S corporations as "incorporated pocketbooks" that generate substantial amounts of passive income, such as rents, interest, dividends, or royalties.[28] In this regard, the tax serves much the same function as the personal holding company tax for C corporations.[29] The goal of the personal holding company tax is to encourage the prompt payment of dividends that result in an immediate second level of taxation of corporation earnings.

Although the terminology, classification, and statutory structure are different, a C corporation only becomes a personal holding company when its passive investment income exceeds 60 percent of the gross income of the corporation.[30] The proposal to modify the S corporation tax provisions, to increase the passive income threshold from 25 percent to 60 percent, is presumably based on the analogies to the personal holding company provisions, and would be a desirable change for many S corporations.

G. Repeal Excess Passive Investment Income as a Termination Event

If the origins of the section 1375 tax are somewhat obscure, the origins of the terminating event are even more obscure. Under current law, if the passive investment income of an S corporation exceeds the 25-percent gross receipts threshold for three consecutive years, and the S corporation has accumulated earnings and profits at the end of the third year, the corporation loses its status as an S corporation, and thus reverts to the status of a C corporation.[31] There is widespread support for this change, given that there is no analogous provision that applies to personal holding companies. In other words, a personal holding company may be subject to the tax for several consecutive years without any penalty other than the imposition of an additional corporate-level tax for those years. To impose the additional penalty of termination of its status does seem to be unwarranted.

These two proposals relating to the passive investment income of an S corporation are essentially independent of each other. The proponents of

[27] IRC Section 1375(a).
[28] IRC Section 1362(d)(3)(C) contains the applicable definition of "passive investment income" for purposes of the section 1375 tax. See IRC Section 1375(b)(3).
[29] *See* IRC Section 541 et seq.
[30] IRC Section 542(a)(1).
[31] IRC Section 1362(d)(3).

these proposals would likely desire to see both of them enacted, but might be almost as pleased with the enactment of either proposal.

H. Tax Rate Applicable to Built-in Gains Tax and the Tax on Passive Investment Income

None of the proposals being discussed in this hearing address this issue, but I wanted to raise one other issue that has not been recently addressed. Both of the corporate-level taxes imposed on S corporations, *i.e.*, the tax on recognized built-in gains and the tax on excess passive investment income, are designed to replicate the treatment of a C corporation that recognized an item of income, pays tax on that item, and distributes the after-tax amount to its shareholders promptly. This tax structure reasonably achieved this objective until the maximum individual rate on corporate dividends was reduced to 15 percent.[32] In some cases, depending on the type of income that produces the corporate-level tax for the S corporation, the corporation and its shareholders may be subject to a *greater* tax burden than would have applied if the corporation had remained a C corporation. Where the income or gain is subject to a 35-percent tax at both the corporate and shareholder levels, the tax burden is actually worse for the S corporation.[33] To the extent that the 15-percent tax rate remains as a feature of the individual income tax beyond its scheduled expiration of 2010, further consideration of the rates applicable to corporate-level taxes would be in order.

V. Conclusion

I applaud the subcommittee for giving thoughtful consideration to the proposed reform and expansion of the S corporation form. While not advocating any specific proposals, I hope that I have given the members some insights into the policy considerations that may guide the further development of these proposals. I would be pleased to answer any questions you may have.

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[32] IRC Section 1(h)(11).

[33] For example, if a C corporation has $100 of taxable income, and is subject to a 35-percent tax rate, the corporate-level income tax would be $35. The corporation would then distribute $65, the amount remaining after taxes, to the shareholders, and the $65 distribution would be subject to approximately $10 of shareholder-level tax at a 15-percent tax rate. The shareholder would be entitled to retain $55 after full payment of corporate- and shareholder-level taxes. In contrast, assume that an S corporation recognizes $100 of rent or interest income, or ordinary gain, that is subject to either of the two corporate-level taxes. The shareholder receives the same $65 after payment of corporate-level taxes, but is subject to a tax of approximately $23 (35% of $65). Thus, the shareholder of an S corporation retains only $42 after full payment of corporate- and shareholder-level taxes.