

**BACKGROUND AND PROPOSALS
RELATING TO S CORPORATIONS**

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 19, 2003

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for June 19, 2003, on S corporation tax reform. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides background and a description of proposals relating to S corporations.

¹ This document may be cited as follows: *Joint Committee on Taxation, Background and Proposals Relating to S Corporations* (JCX-62-03), June 18, 2003.

I. BACKGROUND

Present Law

In general

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders.² The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.

S corporation defined

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans) who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts³, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, a Domestic International Sales Corporation ("DISC") or former DISC.

A corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded. Certain debt ("straight debt") which is not convertible into stock and the interest with respect to which is not contingent on the profits of the issuer or similar factors is not treated as a second class of stock.

² The pass-through treatment of items generally follows the partnership rules; the items pass through to the shareholders on a pro rata basis.

³ Because individuals generally are not allowed to deduct amounts added to reserves, this limitation was made applicable to S corporations.

Treatment of former C corporations and their shareholders

In general, an election by an existing C corporation to be treated as an S corporation is not a taxable event.⁴ However, special rules apply to these corporations that are intended to prevent avoidance of otherwise applicable C corporation tax consequences.

Built-in gain tax—A former C corporation with net built-in gain at the time the S election becomes effective is subject to tax, at the highest corporate tax rate, on the items of built-in gain when the items are disposed of by the S corporation within the 10-year period after becoming an S corporation. The gain, net of tax, is also taken into account by the shareholders. The tax is imposed on the corporation on gains that accrued while it was a C corporation because no corporate level tax is imposed at the time of converting to an S corporation.

Excess net passive income—An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income. These rules were intended to discourage the use of an S corporation election to avoid a shareholder level tax on earnings that had accumulated while a C corporation.

“Excess net passive income” is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. “Net passive income” is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. “Passive investment income” generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains).

Distributions—Distributions by S corporations that are former C corporations of earnings and profits are taxable as dividends to its shareholders. A former C corporation may distribute an amount up to its accumulated S corporation income (“accumulated adjustments account”) before distributions are taxed as dividends.

Trusts as shareholders

Generally, a trust is taxable at graduated rates on its taxable income. In computing the trust’s taxable income, a deduction is allowed for income distributed to its beneficiaries. In addition, property held by certain trusts is treated as owned directly by the grantor of the trust for Federal income tax purposes. The taxation of trusts holding stock in an S corporation differs from the taxation of trusts under these rules.

⁴ An exception is the tax on LIFO recapture.

The share of income of an S corporation whose stock is held by a qualified subchapter S trust (“QSST”), with respect to which the beneficiary makes an election, is taxed to the beneficiary. A QSST generally is a trust with one individual income beneficiary for the life of the beneficiary.

The share of income of an S corporation whose stock is held by an electing small business trust (“ESBT”) is taxed to the trust at the maximum individual rates. An ESBT generally is an electing trust all of whose beneficiaries are eligible S corporation shareholders. For purposes of determining the maximum number of shareholders, each person who is entitled to receive a distribution from the trust (“potential current beneficiary”) is treated as a shareholder during the period the person may receive a distribution from the trust.

Qualified subsidiary corporations

A corporation all of whose stock is held by an S corporation is treated as a qualified subchapter S subsidiary if the S corporation so elects. If an election is made, the subsidiary corporation is disregarded for income tax purposes and its assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and items of the parent S corporation.

Legislative History

Subchapter S of the Code was originally enacted in 1958 in order to diminish the effect of Federal income taxes in the organizational choice of small businesses, and to permit incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder levels.⁵ The provision was originally limited to domestic corporations with 10 or fewer shareholders.

The Subchapter S Revision Act of 1982 revised the provisions of Subchapter S to correspond more closely with the partnership taxation provisions, but without adopting many of the complexities of partnership taxation.⁶ The Act was intended to remove restrictions and

⁵ See S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958). According to the Report, noncorporate tax treatment may be preferred because: (i) owners may not wish business earnings to be subject to two levels of tax (once when earned and again when distributed); (ii) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; (iii) owners may wish to use losses generated by the business to offset income from other sources; and (iv) the owners may not wish tax to be imposed under the corporate tax base (which may include items not applicable to individuals).

⁶ For example, the rules in sections 704(b) and (c), relating to allocations; sections 731-737, relating to distributions; section 751, relating to “hot assets” producing ordinary income; and sections 734(b) and 743(b), relating to elective basis adjustments, were not adopted in order to retain relative simplicity.

“traps for the unwary” that had existed under the subchapter as enacted.⁷ That Act also increased the maximum number of shareholders to 35.

The Small Business Job Protection Act of 1996 increased the maximum number of shareholders to 75 and liberalized the types of persons that could be shareholders in an S corporation. That Act also allowed certain financial institutions to become S corporations.⁸

In 1996, the Internal Revenue Service (“IRS”) issued the “check-the-box” regulations⁹ that allow an unincorporated entity to elect to be taxed as either a partnership or corporation. In recent years the growth of limited liability companies, which can provide owners with protection from liability and partnership tax treatment, has changed the relative importance of subchapter S. Limited liability companies may be organized in all 50 states and the District of Columbia. The IRS first ruled that a limited liability company could be treated as a partnership for Federal tax purposes in 1988.¹⁰

In general, the history of subchapter S illustrates that Congress desires small businesses to achieve the benefits of pass-through taxation similar to partnerships without the complexities of the partnership tax rules. Although some argue that the proliferation of limited liability companies and the flexibility afforded by the check-the-box regulations reduces the need for subchapter S, others argue that the relative simplicity of subchapter S is desirable and worth retaining. In addition to its relative simplicity, subchapter S allows a C corporation to elect to be an S corporation without the imposition of any liquidating tax that would apply if the corporation liquidated and a partnership or limited liability company were formed. S corporations (but not entities treated as partnerships) may engage in tax-free reorganizations with C corporations. Some business owners may prefer to conduct their business as a state law corporation, rather than as a partnership or limited liability company, because they are familiar with the established corporate law and governance structure. As additional complexity is added to the subchapter S rules, the merits of these arguments must be compared to the costs of maintaining two separate pass-through regimes for taxing business income.

The provisions of subchapter S were enacted in 1958 and substantially modified in 1982 on the premise that all income of the S corporation (including all gains on the sale of stock) would be subject to a shareholder-level income tax. This underlying premise allows the rules

⁷ See H. Rep. 97-640, 1 (1982).

⁸ See GAO/GGD-00-159, *Banking Taxation, Implications of Proposed Revisions Governing S-Corporations on Community Banks* (June 23, 2000), for discussion of issues relating to community banks electing subchapter S.

⁹ Treas. Reg. sec. 301.7701-3. These regulations replaced the former entity classification regulations requiring an examination of the presence or absence certain corporate characteristics.

¹⁰ Rev. Rul. 88-76, 1988-2 C. B. 360 (regarding an organization operating under the Wyoming Limited Liability Company Act).

governing subchapter S corporations to be relatively simple (in contrast, for example, to the partnership tax rules of subchapter K) because of the lack of concern about “transferring” income to non-taxpaying persons.¹¹

¹¹ See S. Rept. 104-282, 61 (1996).

II. DATA ON SMALL BUSINESS AND S CORPORATIONS

Trends in Use of Business Entities, 1978-2000

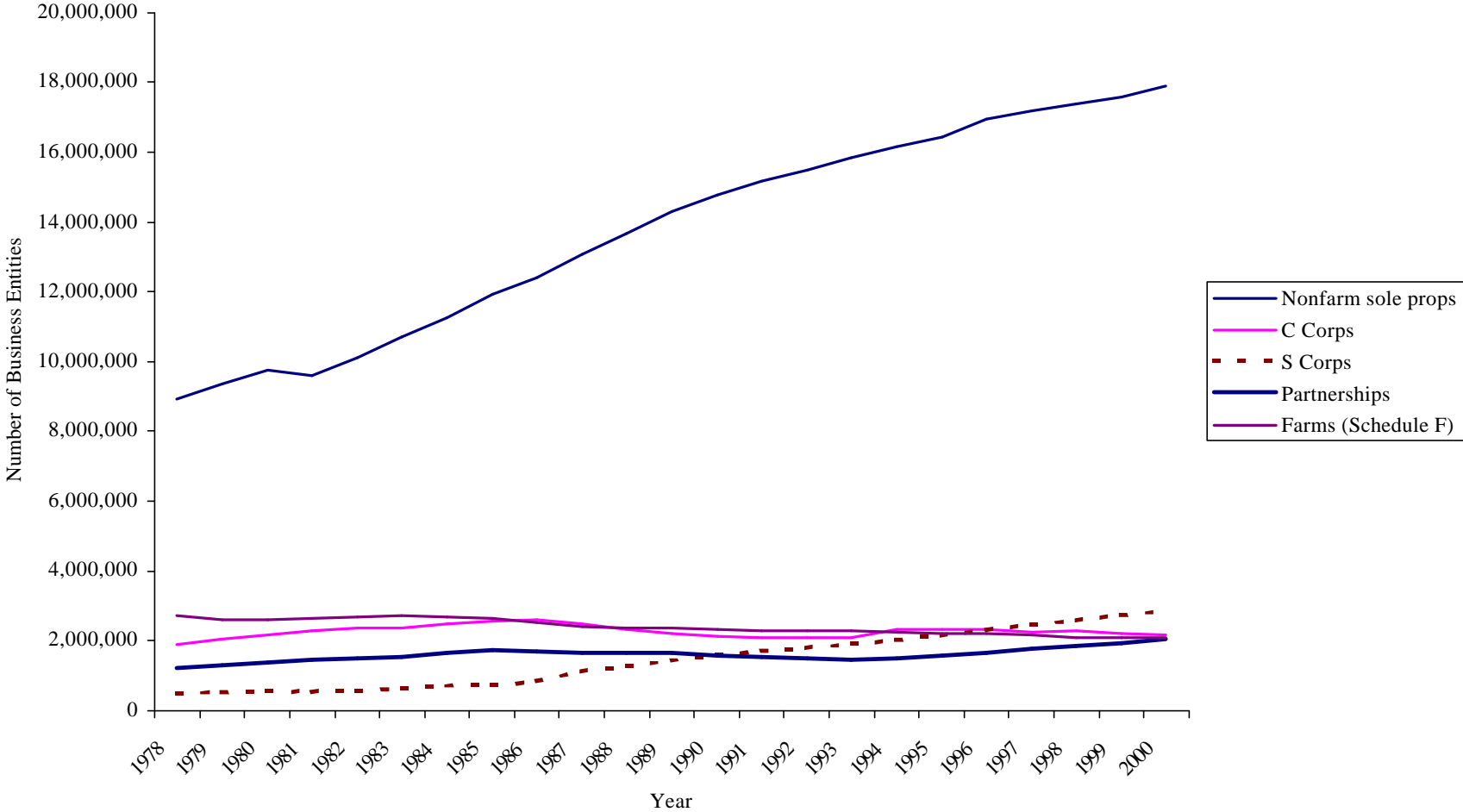
Returns filed by C corporations, S corporations, partnerships, non-farm sole proprietors, and farming enterprises

Figure 1 and Table 1 show data from the Internal Revenue Service's Statistics of Income ("SOI") regarding the number of tax returns filed by different forms of business organizations from 1978 to 2000.¹² In these data, farms are measured solely by reference to those taxpayers who report income (or loss) on Schedule F of Form 1040. Other taxpayers engaged in agricultural enterprises may use a separate entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Throughout the period 1978 to 2000, nonfarm sole proprietorships made up the vast majority of businesses. The S corporation is the second most numerous business form. In 2000, S corporations constituted 10.6 percent of all business entities. Over the past two decades S corporations have grown from approximately three percent of all business entities to over 10 percent.

¹² These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C to Form 1040) and who file a farm income return (Schedule F to Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; the data reported here count only one sole proprietorship. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Thus, the data are not perfectly comparable across entity classification.

**Figure 1.—Number of Different Types of Business Returns,
1978-2000**



**Table 1.--Number of Different Types of Business Returns Relative to
All Business Returns, 1978-2000**

Year	Sole Proprietorships	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	545,389	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table 2 reports the rate of growth in the number of different types of business entities. The growth rate of all entities was greater for the period 1978 to 1988 than for the period 1988 to 1998. The number of farm returns generally declined through the 22-year period. While the relative share of nonfarm sole proprietorships increased after 1986, the growth rate in their numbers did not rise from that of earlier periods and has in fact slowed in the 1990s. The increase in the relative share of nonfarm sole proprietorships is an artifact of the decline in the absolute number of partnerships and C corporations following the Tax Reform Act of 1986. The number of each of those forms declined each year from 1987 through 1993. At the same time, the number of S corporations has increased threefold between 1986 and 2000. The growth in the number of S corporations was most dramatic immediately following 1986; in the past few years, growth rates have returned to the range of pre-1986 growth rates. The number of S corporations also grew rapidly following the Subchapter S Revision Act of 1982.

**Table 2.—Average Annual Rate of Growth in Business Entities
(percent)**

Business	1978-1989	1989-2000	1978-2000
Nonfarm sole proprietorship	4.4	2.1	3.2
C corporation	1.4	-0.1	0.6
S corporation	10.4	6.6	8.5
Partnerships	2.6	2.1	2.4
Farms (Schedule F)	-1.2	-1.1	-1.2
Total	3.1	1.9	2.7

Source: Joint Committee on Taxation staff calculations.

As a consequence of the changing rates of growth of different forms of business entities, the distribution of different types of business has changed since 1978, with sole proprietorships and S corporations growing in relative shares of business entities and farms and C corporations declining in relative shares. Figures 2, 3, and 4, below, display the percentage distribution of different types of business returns for 1978, 1989, and 2000.

Figure 2.—Percentage Distribution of Different Types of Business Returns, 1978

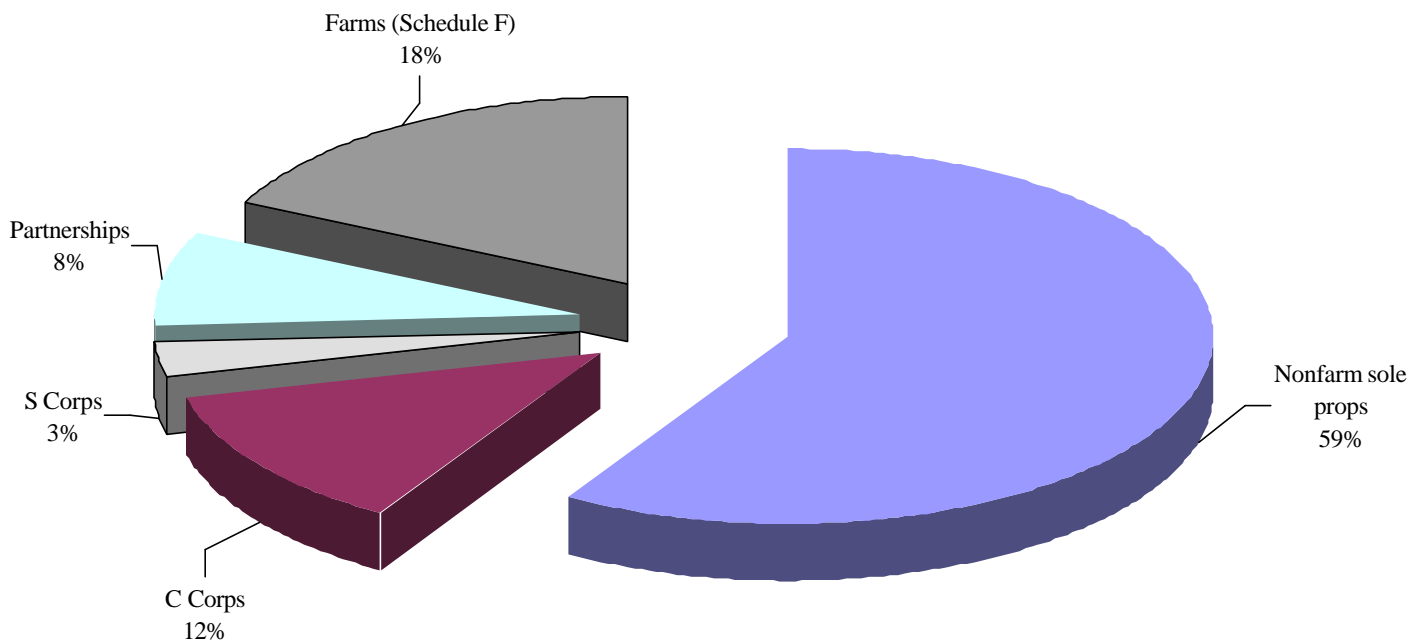


Figure 3.—Percentage Distribution of Different Types of Business Returns, 1989

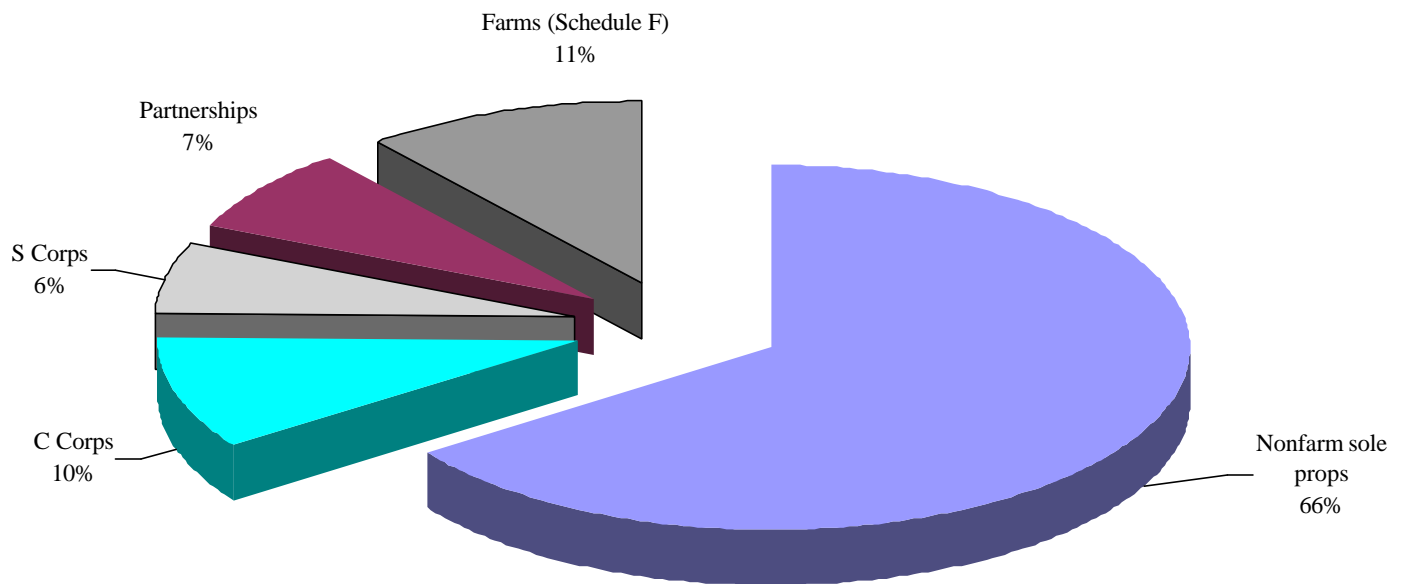
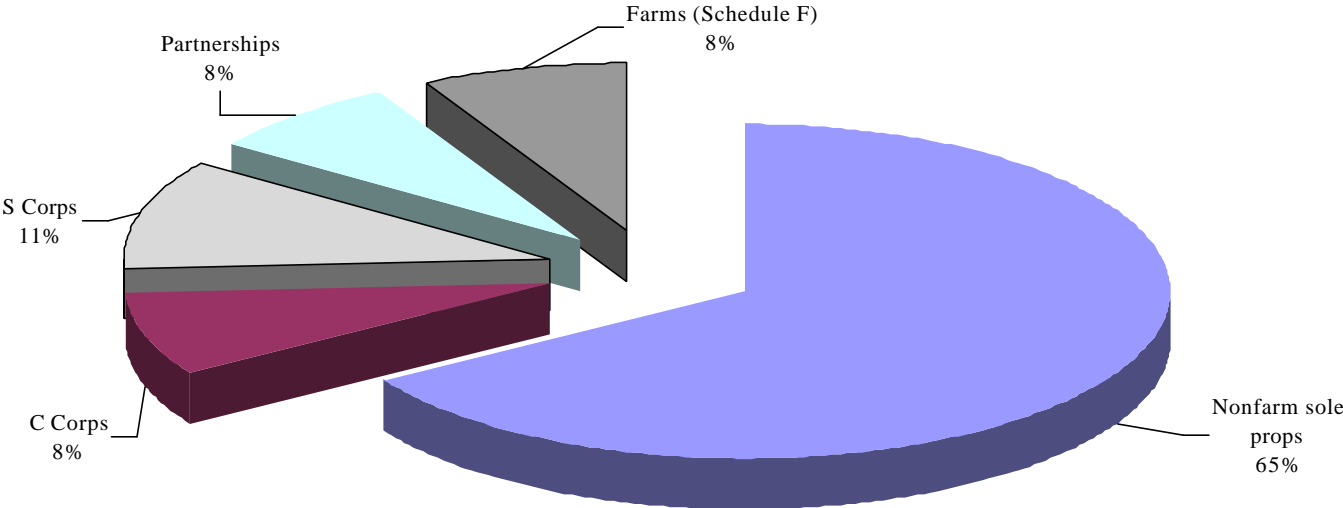


Figure 4.—Percentage Distribution of Different Types of Business Returns, 2000



The growth of limited liability companies

The use of the limited liability company (“LLC”) as an entity is a development of the past several years. Most LLCs filed the partnership reporting form for Federal reporting purposes and their numbers, assets, and gross receipts are counted among the partnership data reported in Tables 1 and 2 and Figures 1-4 above. Table 3 and Figure 5, below, decompose the number of partnerships for the period 1990 through 2000 into general partnerships, limited partnerships, and LLCs.¹³ Figure 5 documents the rapid growth of LLCs relative to other partnership forms over the past several years. Since 1996, LLCs have grown at a rate of 34 percent per year.

Table 3.—Number of Partnership Returns by Type, 1990-2000
Type of Partnership

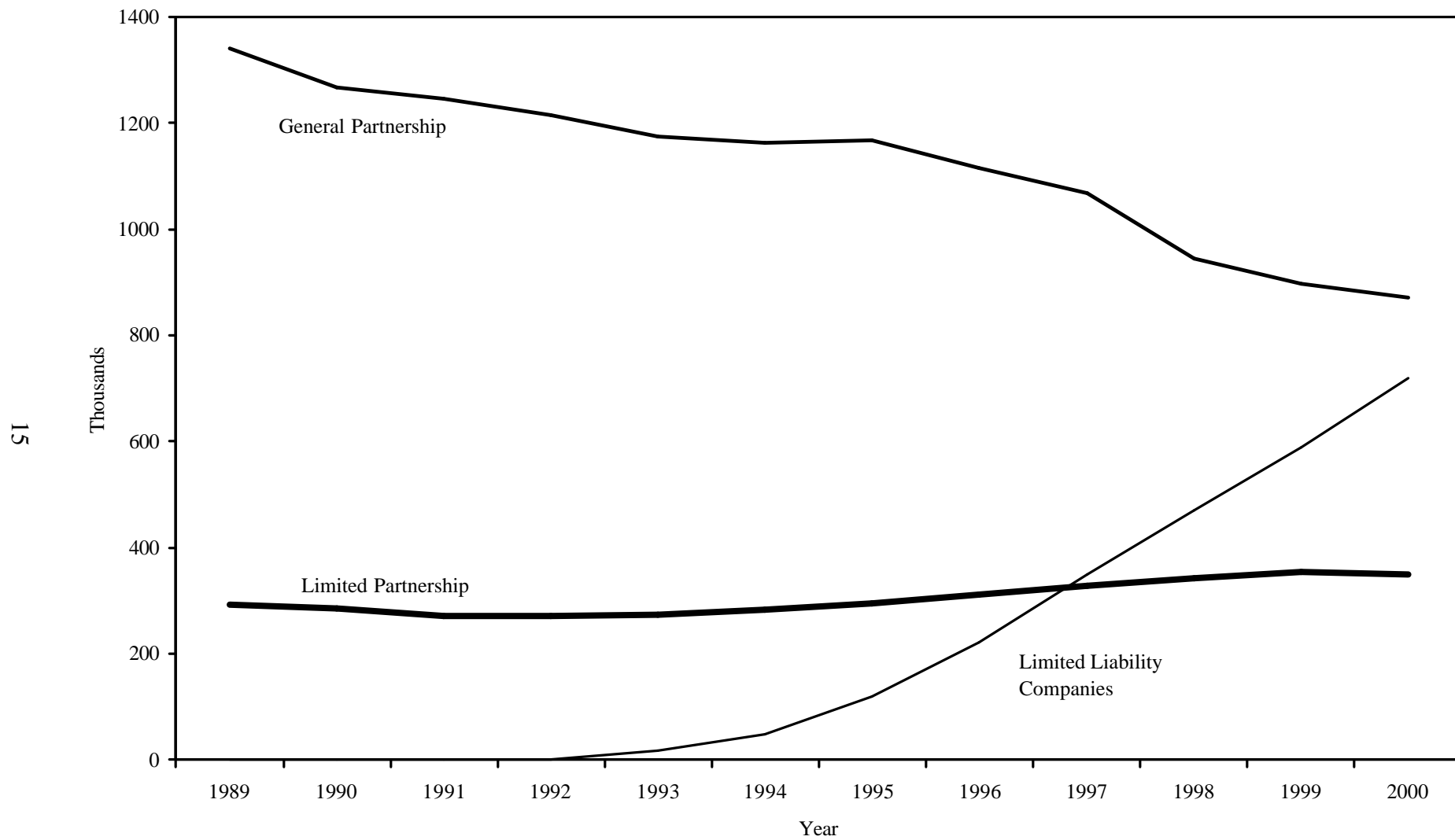
Year	General Partnerships (thousands)	Limited Partnerships (thousands)	Limited Liability Companies (thousands)
1990	1,267	285	n.a.
1991	1,245	271	n.a.
1992	1,214	271	n.a.
1993	1,176	275	17
1994	1,163	283	48
1995	1,167	295	119
1996	1,116	311	221
1997	1,069	329	349
1998	945	343	470
1999	898	354	589
2000	872	349	719

n.a. - not available.

Source: Bill Pratt, “Partnership Returns, 2000,” *SOI Bulletin*, 22, Fall 2002.

¹³ The data in Table 3 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, the IRS has excluded from this decomposition those businesses that checked either the “limited liability partnership” box, the “other” box, or those partnerships that identified themselves as foreign partnerships on Form 1065, Schedule B, line 1. See, Alan Zempel, “Partnership Returns, 1998,” *SOI Bulletin*, 20, Fall 2000 and Bill Pratt, “Partnership Returns, 2000,” *SOI Bulletin*, 22, Fall 2002.

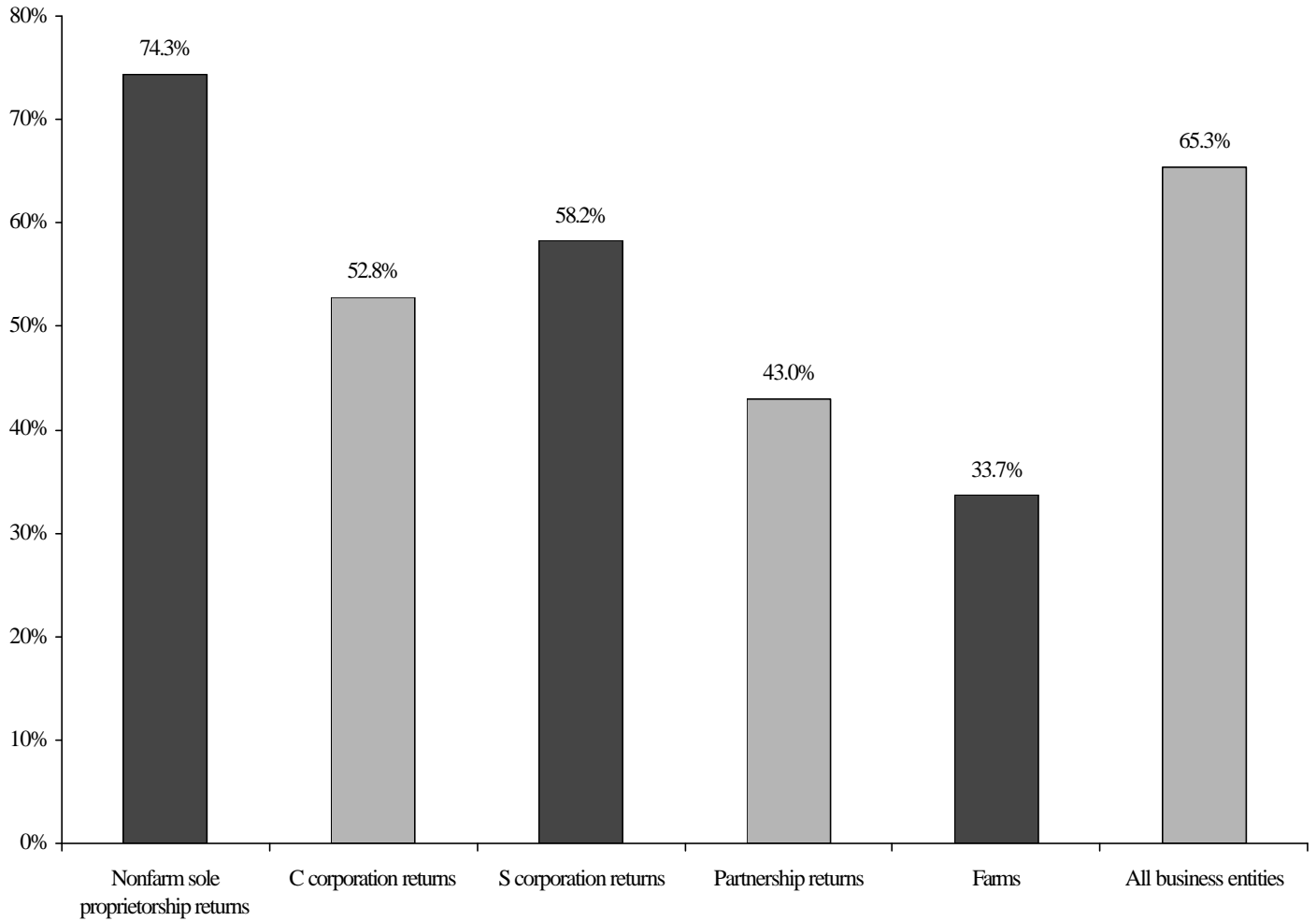
Figure 5.—Partnership Returns by Type of Partnership, 1989-2000



Businesses reporting net income

It is important to recognize that in any given year a substantial number of business enterprises report a loss. Figure 6, below, reports for 2000 the percentage of businesses by type of entity that reported net income.

Figure 6.—Percentage of Business Entities with Net Income, 2000



Source: JCT staff tabulations from SOI data.

Size distribution of C corporations, S corporations, partnerships, and non-farm sole proprietorships

While one may often associate small businesses with organization in the form of a sole proprietorship, a partnership, or an S corporation, there is not an ironclad correspondence between the size of the business and the form of organization. While many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small and not all businesses organized as C corporations are large. One can use SOI data on assets and gross receipts to measure the size of businesses in order to sort out how small businesses are arrayed across the different forms of organization.

Tables 4 through 7 display 2000 SOI data on C corporations, S corporations, partnerships, and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and gross receipts. For sole proprietorships (Table 7), there is no tax data on assets, so the table uses only gross receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 850,000 corporations have assets under \$50,000, approximately 40 percent of the total number of C corporations. For S corporations, approximately one half have assets under \$50,000.

The concentration of assets differs among the three entity forms. C corporations have the largest disparity in asset holding. Firms with over \$100 million in assets, which represent 0.84 percent of all C corporations, hold 95 percent of the assets in C corporations. By comparison, partnerships with \$100 million or more in assets constitute 0.36 percent of all partnerships and these businesses own only 62.5 percent of all assets owned by partnerships. S corporations with \$100 million or more in assets constitute only 0.05 percent of all S corporations and account for 21 percent of all assets owned by S corporations.

When businesses are classified by gross receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of quite small C corporations (more than 450,000 corporations with gross receipts less than \$25,000, nearly 23 percent of the number of C corporations). But across the other forms of organization there are higher percentages of businesses with small amounts of gross receipts. For nonfarm sole proprietorships, 67 percent have gross receipts under \$25,000. For S corporations, 26 percent report gross receipts of \$25,000 or less.

As with assets, the dispersion of gross receipts across the classifications is more skewed for C corporations and partnerships than for S corporations. C corporations with over \$50 million in gross receipts, which represent approximately 0.73 percent of all C corporations, collect over 80 percent of gross receipts of all C corporations. For partnerships, approximately the 0.2 percent of partnerships with gross receipts in excess of \$50 million report 68 percent of all partnership gross receipts. For S corporations, 0.3 percent of S corporations with gross receipts in excess of \$50 million report 29 percent of S corporation gross receipts. For non-farm sole proprietorships, fewer than 0.02 percent of such businesses report gross receipts in excess of \$50 million, and these businesses report less than six percent of all non-farm sole proprietorship gross receipts.

Table 4.--Distribution of C Corporations, 2000

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
\$0 or less	135,277	0	6.19%	0.00%
\$1 to \$25,000	507,207	4,561	29.41%	0.01%
\$25,001 to \$50,000	221,757	8,111	39.56%	0.03%
\$50,001 to \$100,000	272,301	19,815	52.02%	0.07%
\$100,001 to \$250,000	365,712	59,948	68.76%	0.20%
\$250,001 to \$500,000	237,187	84,392	79.62%	0.39%
\$500,001 to \$1,000,000	172,389	120,757	87.51%	0.66%
\$1,000,001 to \$10,000,000	216,080	595,066	97.40%	1.97%
\$10,000,001 to \$50,000,000	30,913	680,850	98.81%	3.48%
\$50,000,001 to \$100,000,000	7,685	546,532	99.16%	4.69%
More than \$100,000,000	18,287	43,116,128	100.00%	100.00%
Total	2,184,795	45,236,160		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
\$0 or less	255,181	-234	11.68%	0.00%
\$1 to \$2,500	53,783	54	14.14%	0.00%
\$2,501 to \$5,000	29,389	107	15.49%	0.00%
\$5,001 to \$10,000	51,460	370	17.84%	0.00%
\$10,001 to \$25,000	101,905	1,722	22.51%	0.01%
\$25,001 to \$50,000	122,695	4,546	28.12%	0.04%
\$50,001 to \$100,000	187,857	13,730	36.72%	0.14%
\$100,001 to \$250,000	342,738	57,315	52.41%	0.53%
\$250,001 to \$500,000	288,970	103,929	65.63%	1.24%
\$500,001 to \$1,000,000	261,326	185,588	77.60%	2.51%
\$1,000,001 to \$10,000,000	422,236	1,194,954	96.92%	10.67%
\$10,000,001 to \$50,000,000	51,264	1,037,132	99.27%	17.76%
More than \$50,000,000	15,991	12,038,877	100.00%	100.00%
Total	2,184,795	14,638,090		

Table 5.--Distribution of S Corporations, 2000

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
\$0 or less	193,628	0	6.77%	0.00%
\$1 to \$25,000	894,381	7,942	38.04%	0.44%
\$25,001 to \$50,000	342,041	12,551	49.99%	1.14%
\$50,001 to \$100,000	344,662	24,950	62.04%	2.54%
\$100,001 to \$250,000	440,476	70,465	77.44%	6.47%
\$250,001 to \$500,000	246,616	86,559	86.06%	11.31%
\$500,001 to \$1,000,000	168,592	119,036	91.96%	17.95%
\$1,000,001 to \$10,000,000	206,394	571,139	99.17%	49.85%
\$10,000,001 to \$50,000,000	20,408	392,270	99.89%	71.75%
\$50,000,001 to \$100,000,000	1,925	132,721	99.95%	79.17%
More than \$100,000,000	1,355	373,079	100.00%	100.00%
Total	2,860,478	1,790,712		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
\$0 or less	412,978	-668	14.44%	-0.02%
\$1 to \$2,500	74,341	87	17.04%	-0.02%
\$2,501 to \$5,000	44,629	162	18.60%	-0.01%
\$5,001 to \$10,000	68,631	505	21.00%	0.00%
\$10,001 to \$25,000	149,215	2,514	26.21%	0.07%
\$25,001 to \$50,000	181,581	6,767	32.56%	0.26%
\$50,001 to \$100,000	288,224	21,108	42.64%	0.85%
\$100,001 to \$250,000	493,046	81,901	59.87%	3.15%
\$250,001 to \$500,000	385,896	138,249	73.36%	7.03%
\$500,001 to \$1,000,000	318,906	223,419	84.51%	13.30%
\$1,000,001 to \$10,000,000	385,675	1,071,404	97.99%	43.35%
\$10,000,001 to \$50,000,000	49,074	996,392	99.71%	71.31%
More than \$50,000,000	8,282	1,022,833	100.00%	100.00%
Total	2,860,478	3,564,673		

Table 6.--Distribution of Partnerships, 2000

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
\$0 or less	590,473	-60,359	28.70%	-0.90%
\$1 to \$25,000	237,445	2,139	40.24%	-0.87%
\$25,001 to \$50,000	105,285	3,833	45.36%	-0.81%
\$50,001 to \$100,000	128,394	9,424	51.60%	-0.67%
\$100,001 to \$250,000	229,487	37,424	62.75%	-0.11%
\$250,001 to \$500,000	196,499	70,830	72.30%	0.95%
\$500,001 to \$1,000,000	183,006	130,504	81.20%	2.89%
\$1,00,001 to \$10,000,000	328,423	967,494	97.16%	17.35%
\$10,000,001 to \$50,000,000	44,739	912,256	99.33%	30.98%
\$50,000,001 to \$100,000,000	6,258	435,471	99.64%	37.48%
More than \$100,000,000	7,491	4,185,127	100.00%	100.00%
Total	2,057,500	6,694,143		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
\$0 or less	1,284,123	0	62.41%	0.00%
\$1 to \$2,500	48,643	55	64.78%	0.00%
\$2,501 to \$5,000	24,916	94	65.99%	0.01%
\$5,001 to \$10,000	30,174	218	67.45%	0.02%
\$10,001 to \$25,000	75,362	1,245	71.12%	0.08%
\$25,001 to \$50,000	78,518	2,876	74.93%	0.21%
\$50,001 to \$100,000	90,994	6,448	79.36%	0.52%
\$100,001 to \$250,000	139,217	23,043	86.12%	1.62%
\$250,001 to \$500,000	92,306	33,042	90.61%	3.20%
\$500,001 to \$1,000,000	75,179	53,731	94.26%	5.77%
\$1,000,001 to \$10,000,000	101,123	285,424	99.18%	19.40%
\$10,000,001 to \$50,000,000	12,816	270,988	99.80%	32.34%
More than \$50,000,000	4,129	1,416,435	100.00%	100.00%
Total	2,057,500	2,093,599		

Table 7.--Distribution of Non-farm Sole Proprietorships, 2000

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
\$0 or less	744,458	0	4.16%	0.00%
\$1 to \$2,500	3,725,905	4,349	24.97%	0.43%
\$2,501 to \$5,000	1,920,789	6,964	35.70%	1.12%
\$5,001 to \$10,000	2,368,238	16,980	48.93%	2.80%
\$10,001 to \$25,000	3,303,747	53,464	67.38%	8.09%
\$25,001 to \$50,000	2,222,008	78,987	79.79%	15.91%
\$50,001 to \$100,000	1,620,707	115,569	88.85%	27.35%
\$100,001 to \$250,000	1,265,942	194,855	95.92%	46.63%
\$250,001 to \$500,000	453,235	156,519	98.45%	62.13%
\$500,001 to \$1,000,000	187,188	125,017	99.49%	74.50%
\$1,000,001 to \$10,000,000	88,806	174,571	99.99%	91.78%
\$10,000,001 to \$50,000,000	1,523	28,584	100.00%	94.61%
More than \$50,000,000	245	54,478	100.00%	100.00%
Total	17,902,791	1,010,337		

Distribution of S Corporations by Industry

Table 8, below, details the distribution of S corporations by industry. Businesses classifying themselves as offering professional, scientific, and technology services account for 14.9 percent of all S corporations. Construction businesses account for 12.8 percent of all S corporations. Retail trade and rental real estate each constitute more than 11 percent of all S corporations.

Retail trade accounts for almost 24 percent of all S corporation gross receipts while wholesale trade accounts for 18 percent of S corporation gross receipts. Although manufacturing enterprises constitute five percent of S corporations, these enterprises account for approximately 15 percent of S corporation assets and S corporation gross receipts.

Table 8.—Distribution of S Corporations by Industry, 2000

Industry	Percent of all S Corporations	Percent of Total S Corporation Assets	Percent of Total S Corporation Revenues
Professional, Scientific, and Technology Services	14.89	4.00	6.24
Construction	12.78	11.90	14.34
Retail Trade	11.87	12.69	23.84
Real Estate & Rental and Leasing	11.18	10.61	1.87
Other Services	6.11	1.46	2.19
Wholesale Trade	5.77	10.94	18.19
Accommodation & Food Services	5.73	3.56	3.34
Manufacturing	5.13	15.00	14.64
Health Care & Social Assistance	5.00	1.53	2.77
Admin, Supportive, Waste Management, and Remediation Services	4.86	1.67	3.06
Finance and Insurance	4.08	7.01	2.05
Transportation & Warehousing	3.11	2.58	2.56
Agriculture, Forestry, Fishing, and Hunting	2.53	2.31	1.36
Leisure, Accommodation, and Food Services	2.18	1.36	0.82
Information	2.17	3.41	1.49
Educational Services	0.76	0.20	0.23
Management of Companies (Holding Companies.)	0.74	8.06	0.32
Mining	0.62	1.41	0.51
Not Elsewhere Classified	0.36	0.04	0.03
Utilities	0.09	0.22	0.11
Wholesale & Retail Not Elsewhere Classified	0.04	0.02	0.02

Source: JCT staff tabulations for SOI data.

III. PROPOSALS

1. The Subchapter S Modernization Act of 2003

H.R.1896, the “Subchapter S Modernization Act of 2003”, introduced by Mr. Shaw, Mr. Matsui, Mr. McNinnis, and Mrs. Jones, makes the following amendments to the tax provisions relating to S corporations:

Eligible Shareholders of an S Corporation

- Certain family members may elect to be treated as one shareholder for purposes of determining the number of shareholders in an S corporation. A family includes a common ancestor (not more than six generations removed from the youngest generation of shareholders) and the lineal descendants (and spouses) of the common ancestor.
- Nonresident aliens are allowed to be eligible shareholders; S corporation income allocated to a nonresident alien shareholder is taxed under rules similar to the partnership rules taxing income to a foreign partner.
- An individual retirement account (“IRA”) holding stock in a bank¹⁴ on the date of enactment of the provision is an eligible S corporation shareholder with respect to that stock. Income with respect to the stock is treated as unrelated business taxable income.
- The sale of stock by an IRA to the individual beneficiary of the IRA is not a prohibited transaction if the sale is made pursuant to the corporation making a subchapter S election.
- The maximum number of eligible shareholders is increased from 75 to 150.

Qualification and Eligibility Requirements of S Corporations

- An S corporation may issue qualified preferred stock (i.e., nonparticipating preferred stock, as defined for purposes of determining members of an affiliated group of corporations eligible to file a consolidated return, determined without regard to voting rights and convertibility) that is not treated as a second class of stock. Distributions with respect to the stock are deductible by the S corporation and includible in the income of the holder.

¹⁴ The term “bank” is defined in section 581.

- Convertible debt qualifies as “straight debt” if the terms are substantially the same as could have been obtained by the S corporation from a person who is not a related party.
- Excess net passive income no longer causes a subchapter S election to terminate; instead the tax on excess net passive income applies.
- The tax on excess net passive income applies only if the gross receipts from passive investment income exceeds 60 percent (rather than 25 percent) of total gross receipts; capital gain is not treated as an item of passive income.
- A shareholder’s basis in S corporation stock is not reduced by the amount of appreciation in charitable contributions of appreciated property made by the S corporation.¹⁵

Treatment of S Corporation Shareholders

- A shareholder’s loss on the liquidation of an S corporation is treated as an ordinary loss to the extent ordinary income items increased the shareholder’s basis in the stock.
- Suspended passive activity loss deductions are allowed to an S corporation that converted from a C corporation under the rules generally applicable to other suspended loss deductions.
- Suspended S corporation losses with respect to stock held by a shareholder are transferred if the stock is transferred incident to a decree of divorce.
- Qualified subchapter S trust income beneficiaries treat dispositions of stock by the trust as dispositions by the beneficiary for purposes of the at-risk rules and the passive activity loss rules.
- Interest paid or incurred by an electing small business trust on indebtedness to acquire S corporation stock is deductible by the trust.
- Unexercised (in whole or in part) powers of appointment are disregarded in determining the potential current beneficiaries of an electing small business trust.
- The electing small business trust distribution rules provide that any distribution attributable to the portion treated as a separate trust shall be treated separately from any portion not so treated.

¹⁵ A similar provision is included in sec. 109 of H.R. 7 (107th Cong.) as passed by the House; in sec. 109 of S. 476 (108th Cong.) as passed by the Senate; and in the President’s Fiscal Year 2004 Budget Proposal.

- Charitable contributions made by an electing small business trust are deductible by the trust and are taken into account in computing the unrelated business taxable income of the charitable organization receiving the contribution.
- Excluded cancellation of indebtedness income does not increase the shareholder's basis in its stock.¹⁶
- For purposes of determining the shareholder's basis in indebtedness of the S corporation, the indebtedness of the S corporation to the shareholder shall include loans made or acquired (by purchase, gift or distribution from another person) by the shareholder, regardless of whether the funds lent by the shareholder to the S corporation were obtained by the shareholder by means of a recourse loan from another person (whether related or unrelated to the shareholder).

Expansion of S Corporation Eligibility for Financial Institutions

- In the case of a bank or bank holding company, interest income and dividends on assets required to be held by the bank or bank holding company are not treated as passive investment income for purposes of the tax on excess net passive income.
- Qualifying director shares are not treated as a second class of stock for purposes of subchapter S. Qualifying director shares means shares in a bank or bank holding company that are held by an individual solely by reason of status as a director of the bank or company and which are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder's status as a director at the same price as the individual acquired the shares. Distributions with respect to the shares are deductible by the corporation and includible in the income of the holder.
- Bad debt reserves of a bank may be recaptured on the making of an S corporation election in either the taxable year beginning with or ending with the year of the election.

Qualified Subchapter S Shareholders

- The IRS may validate an inadvertent invalid qualified subchapter S subsidiary election under the same circumstances that an inadvertent invalid subchapter S election may be validated.

¹⁶ A similar provision was enacted in section 402 of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). The provision overturned the result in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

- Information returns with respect to items of a qualified subchapter S subsidiary may be issued by the subsidiary.
- A sale of stock in a qualified subchapter S subsidiary by an S corporation is treated as a sale of an undivided interest in the underlying assets based on the percentage of stock transferred.
- The “step transaction” doctrine is not applicable to restructurings in connection with the making of a qualified subchapter S subsidiary election. Instead, the election is to be treated as a liquidation of the subsidiary under the usual rules applicable to corporate liquidations of subsidiaries.

Additional Provisions

- The provision, presently applicable to any corporation that was an S corporation for its first taxable year beginning after 1996, eliminating all earnings and profits accumulated in a taxable year beginning before 1983 in which the corporation was an electing small business corporation is extended to all corporations.
- With respect to taxable years beginning before, on, or after July 12, 1995, the consolidated return regulations shall not cause gain or loss to be recognized by reason of an election to be an S corporation or a qualified subchapter S subsidiary.
- Charitable contribution carryovers and other carryovers are deductible in computing the tax on built-in gains of S corporations that are former C corporations in the same manner as net operating loss carryovers; foreign tax credit carryovers may offset the tax on built-in gains.
- In the case of a distribution made by an S corporation with respect to its stock held by an employee stock ownership plan, use of the distributed amount to repay a loan that was used to acquire the stock is not a prohibited transaction.
- The provision that a former S corporation must wait five taxable years to reelect to be an S corporation is inoperative if the termination or revocation occurred prior to the enactment of the bill.

2. The Small Business and Financial Institutions Tax Relief Act of 2003

H.R. 714, the “Small Business and Financial Institutions Tax Relief Act of 2003”, introduced by Mr. McInnis, Mr. Ramstad, Mr. Matsui, Mr. English, Mr. Pomeroy, Mr. Foley, and others makes following amendments to the tax provisions relating to S corporations:

- An IRA holding stock in a bank on the date of enactment of the provision is an eligible S corporation shareholder with respect to that stock. Income with respect to the stock is treated as unrelated business taxable income.
- The sale of stock in a corporation by an IRA to the individual beneficiary of the IRA is not a prohibited transaction if the sale is made pursuant to the corporation making a subchapter S election.
- In the case of a bank or bank holding company, interest income and dividends on assets required to be held by the bank or bank holding company are not treated as passive investment income for purposes of applying the tax on excess net passive income.
- The maximum number of eligible shareholders is increased from 75 to 150.
- Qualifying director shares are not treated as a second class of stock for purposes of subchapter S. Qualifying director shares means shares in a bank or bank holding company that are held by an individual solely by reason of status as a director of the bank or company and which are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder's status as a director at the same price as the individual acquired the shares. Distributions with respect to the shares are deductible by the corporation and includible in the income of the holder.
- Bad debt reserves of a bank may be recaptured on the making of an S corporation election in either the taxable year ending with or beginning with the year of the election.
- The provision¹⁷ reducing corporate tax preferences (including interest of banks on debt to carry certain tax-exempt obligations) for the first three taxable years after a C corporation becomes an S corporation is clarified to specifically state that the reduction does not apply after three taxable years.
- Certain family members may elect to be treated as one shareholder for purposes of determining the number of shareholders. A family includes a common ancestor (not more than three generations removed from the youngest generation of shareholders) and the lineal descendants (and spouses) of the common ancestor.
- An S corporation may issue qualified preferred stock (i.e., nonparticipating preferred stock as defined for purposes of the consolidated return regulations, determined without regard to voting rights and convertibility) distributions with respect to which are deductible by the corporation and includible in income of the holder.

¹⁷ Sec. 1363(b)(4).

- Information returns with respect to items of a qualified subchapter S subsidiary may be issued by the subsidiary.
- A shareholder's basis in S corporation stock is not reduced by the amount of appreciation in charitable contributions of appreciated property made by the S corporation.

3. The Small Business Opportunity and Growth Act of 2003

H.R. 1498, the "Small Business Opportunity and Growth Act of 2003", introduced by Mr. Ramstad, Mr. Crane, Mrs. Johnson, Mr. Herger, Mr. Camp, Mr. Johnson, Mr. English, Mr. Weller, Mr. McInnis, Mr. Foley, Mr. Brady, and Mr. Cox, makes the following amendment:

- The tax on the built-in gain of an S corporation that filed its subchapter S election before March 27, 2003, does not apply to the extent that amounts are reinvested in the S corporation business, used to pay principal or interest on certain corporate debt, or distributed to shareholders to pay Federal, State, and local income taxes on the built-in gain.