

STATEMENT OF DONALD C. ALEXANDER  
OF AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.  
BEFORE THE UNITED STATES SENATE  
COMMITTEE ON FINANCE  
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My topic is the need for reform and simplification of the restrictive rules, largely enacted over 40 years ago, that still shackle the more than 2,500,000 Subchapter S corporations in the United States. While a number of constructive changes were made in 1996, much remains to be done to permit family-owned corporations and banks to conduct their businesses through an entity that provides both limited liability and a means of passing through the entity's income to its owners.

As you know, some years ago Subchapter S corporations were the entity of choice if the owner of a small business wished to obtain the benefits of operating through the corporate form (limited liability) without suffering the detriment of double taxation on the business's earnings. However, after the Treasury's blessing of the limited liability company, plus the Treasury's adoption of check-the-box rules, partnership tax treatment (correctly called "tax nirvana") has been conferred upon entities that were not formerly treated as partnerships. Limited liability companies are clearly preferable to Subchapter S corporations from the Federal tax standpoint; examples of favored treatment are the partnership basis rules (partner's basis includes partnership debt) and liberal disproportionate allocation rules. But some entities, like banks, must conduct their businesses in corporate form and others need to do so. These must use Subchapter S. Moreover, many Subchapter S corporations are locked in to elections made years ago; while they might now prefer to adopt the tax-favored partnership form, they cannot without a heavy tax toll charge. Subchapter S corporations are found on Main Street, not Wall Street. They are not asking for the famous "level playing field", *i.e.*, the favored tax treatment granted to partnerships. Instead, they are simply asking that some of the fetters imposed in another era be removed.

Some past Treasury tax policy officials, particularly those whose practice was concentrated on deal making through partnership “flexibility”, have not been responsive to the proponents of Subchapter S reform. Among the reasons for opposition is the notion that while it is fine for partnerships to seek and obtain tax advantages through a sea of complexity, Subchapter S must be kept simple for simple people. By confusing rigidity with simplicity, this notion creates complexity. Examples are the rules prohibiting a nonresident alien from being a stockholder in a Subchapter S corporation and limiting the number of Subchapter S stockholders. Example 2 of Reg. § 1.701-2(d) shows that a nonresident alien (or the 76<sup>th</sup> stockholder) can participate in a Subchapter S corporation’s business by becoming a partner with the Subchapter S corporation. Why require this maneuver? Why not permit the nonresident alien, or the 76<sup>th</sup> stockholder, to come through the front door?

When she testified for the American Bar Association Tax Section before the House Committee on Small Business on the impact of the Code’s complexity on small businesses, Ms. Pamela Olson, now Deputy Assistant Secretary of the Treasury (Tax Policy) stated:

The definition of an “S corporation” contained in section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than seventy-five shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of Federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.

*The Impact of Complexity in the Tax Code on Small Businesses: Hearing Before the House Subcomm. on Tax, Fin. and Exp. of the Comm. on Small Bus., 106<sup>th</sup> Cong. (statement of Pamela F. Olson).*

Ms. Olson is right. S corporations are indeed disadvantaged, these restrictions are extremely complex, and their removal would greatly simplify the law for Main Street businesses.

These simplifications should include, at least, the following:

1. S corporations should have access to senior equity by the issuance of preferred stock, as well as bank directors' qualifying shares. Payments to owners of such stock or shares should be treated as an expense to the S corporation and ordinary income to the shareholders.
2. The number of S corporation eligible shareholders should be increased from 75 to 150 over a four-year period, thus helping community banks to broaden their ownership and Subchapter S corporations to provide equity to key employees. Members of a family should be treated as one stockholder, as they are for other purposes of the Code.
3. The current draconian rule that terminates S corporation status for corporations that have both subchapter C earnings and profits and that derive more than 25 percent of their gross receipts from passive sources for three consecutive years should be repealed.
4. Capital gains should be excluded from classification as passive income. Capital gains would be subject to a maximum 20 percent rate at the shareholder level, thus conforming to the general treatment of such gains as well as their treatment under the personal holding company rules. Also, interest and dividends on investments maintained by a bank for liquidity and safety and soundness purposes should not be treated as passive income.

5. Nonresident aliens should be permitted to own Subchapter S stock, subject to the limitations applicable to partnerships.
6. Subchapter S corporations should be permitted to issue convertible debt.
7. The provisions relating to qualified subsidiaries of a Subchapter S corporation and relating to trusts permitted to own Subchapter S stock should be modified to make them workable and useful.

Most of the improvements listed above were contained in Senator Hatch's bill, S. 1415, and Representative Shaw's bill, H.R. 689, in the last Congress. As Representative Shaw stated on introduction of his bill:

Today over two million businesses pay taxes as S corporations and the vast majority of these are small businesses. The Subchapter S Revision Act of 1999 is targeted to these small businesses by improving their access to capital preserving family-owned businesses, and lifting obsolete and burdensome restrictions that unnecessarily impede their growth. It will permit them to grow and compete in the next century.

Cong. Rec. E196 (Feb. 10, 1999) (statement of Rep. Shaw).

S corporations operate in every business sector of every state. Typically, they are family-owned and operated businesses or otherwise closely-held organizations that have been reliable engines of job growth and productivity for the domestic economy. The rules adopted in 1958 when S corporations were created, and as subsequently amended, are out of sync with modern economic realities. The S corporation reforms we propose would address the troubling gap between the antiquated laws established forty years ago and the operating and capital needs of S corporations today. These reforms were developed after careful and thorough study. In short, these reforms would

provide the boost, at a critical time, that thousands of small businesses in America need to continue the growth of American entrepreneurship and competitiveness, and they have the strong support of Main Street business organizations, such as the National Federation of Independent Business and the Chamber of Commerce.