S. HRG. 104–241

# HOME OFFICE DEDUCTIONS AND SUBCHAPTER S CORPORATION REFORM

## HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

**S. 327, S. 758, and H.R. 1215**

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# HOME OFFICE DEDUCTIONS AND SUBCHAPTER S CORPORATION REFORM

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**MONDAY, JUNE 19, 1995**

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 2:00 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the subcommittee) presiding.

Also present: Senator Pryor.

## OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN OF THE SUBCOMMITTEE

Senator HATCH. I will be happy to call this meeting to order, and welcome all of you here to this very important hearing on two very important issues for the small business community—the home office deduction and the S corporation reform.*

Small business has proven to be the driving force behind American job creation in the past few years. Our efforts here today are to discuss ways to help these businesses get started, grow and create jobs, and to ease outdated, unreasonable or burdensome tax compliance requirements that they may face—actually, that they do face.

The issue of being able to deduct the legitimate expenses of a home office is of concern to a growing number of American taxpayers. According to the Bureau of Labor Statistics, 31 percent of the American work force over 18 years of age works at home. More than 12 million of those working at home are self-employed individuals whose primary source of income is their work at home.

The migration from the office to the home may be as important to the information revolution as the migration from the farm to the factory was to the industrial revolution.

Unfortunately, the availability of the home office deduction was severely curtailed by the 1993 Supreme Court decisions of *Commissioner* v. *Soliman.* Until the *Soliman* decision, small business owners and professionals who dedicate a space in their homes to use for business activities were generally allowed to deduct their home office expenses, as long as the space was used exclusively, and on a regular basis, for business purposes.

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*See Joint Committee on Taxation print entitled "Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions" (JCS–16–95), May 1995.

Through the *Soliman* decision, the Supreme Court has narrowed significantly the availability of home office deduction by requiring that the home office be the principal location of the business itself. However, this requirement is impossible to meet for many taxpayers with legitimate home office expenses.

For example, since 1993, a self-employed plumber, electrician, interior designer, veterinarian, home remodeler, or virtually any businessperson who actually earns the revenue from his or her business in the home or the office of the customer, has generally been denied the home office deduction.

This is because current law requires the home office to be the "principal place of business" in order to qualify for the deduction. And the principal place of business is considered to be the place where the revenue is earned.

Ironically, if a taxpayer rents office space outside the home, he or she is allowed a full deduction for the cost of the office. But if a taxpayer tries to economize, or chooses to work from the home for a number of other very good reasons, he or she is penalized. Now this is just plain unfair, and should be changed.

S. 327, the Home Office Deduction Act of 1995, which I introduced, and which is cosponsored by 17 of my colleagues in the Senate, seeks to correct this problem by changing the definition of principal place of business to include a home office, if it is the location where the taxpayer performs the essential administrative or management activities of the business.

Our job market is rapidly changing. More and more individuals are choosing to work out of their homes for a variety of family and economic reasons.

I look forward to hearing from our witnesses today, their views on the home office deduction, and the growing importance of working at home.

We will also hear testimony here today about S corporations, and how our tax laws can be streamlined and improved to help these entities compete in today's world and market. There are nearly 2 million S corporations in the United States today, including over 14,000 in my home State of Utah alone. In fact, over 48 percent of all corporations have elected Subchapter S status.

The vast majority of these are small businesses, with 88 percent of S corporations having assets of less than $50 million. These are the size of businesses that have been the most important part of America's job creation engine during the past few years. In fact, during the times of economic recovery, small businesses actually create about 75 percent of U.S. jobs. Therefore, it is vital that Congress establish tax policies that nurture and preserve these benefits.

One of the biggest problems facing small businesses is limited access to outside capital. This problem is particularly difficult for S corporations, which are restricted in the number and type of shareholders they can have, and in their capital structures themselves.

Another problem faced by almost all small businesses is that of keeping the business in the family when the owner or founder dies or wishes to retire. S corporations face some unique problems in this regard because of the particular requirements for S status under today's tax law.

It is clear that S corporations have always operated in a tax compliance environment that is relatively unfriendly. Inadvertent errors or omissions can put the corporation's tax status in jeopardy. Tax traps for the unwary have made life more difficult for S corporation owners since 1958, when Subchapter S of the Internal Revenue Code was enacted.

In response to these problems facing S corporations, Senator Pryor and I introduced S. 758, the S Corporation Reform Act of 1995. This bill currently has 29 cosponsors in the Senate. We believe that S. 758 will address many of the special concerns that S corporations face, so I look forward to the views of each of our witnesses today as to how well this bill meets its objectives. And I want to thank in advance each of our distinguished witnesses for being willing to appear here today.

Our first witness will be Mr. Glen Kohl, Tax Legislative Counsel for the Treasury Department. We welcome you, Mr. Kohl, and we look forward to taking your testimony at this time.

## STATEMENT OF GLEN A. KOHL, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. KOHL. Thank you very much, Mr. Chairman.

I am pleased to present the views of the Administration on S. 758, the S Corporation Reform Act of 1995 and the home office proposal to change the rules for claiming expenses for business use of homes.

As I will explain, we believe certain reforms in both these areas are appropriate, subject to finding suitable revenue offsets for any reforms that lose money.

First, let me address the S corporation issues. By way of background, I should mention that the Administration frequently champions legislation targeted to small business. In OBRA 1993, we supported increasing the expensing from $10,000 to $17,500, and we continue to support revenue-neutral legislation that would further increase expensing for small business. I should point out that one advantage of this benefit is that it applies for all small businesses, regardless of form, and not just S corporations.

Similarly, last week, the President announced a proposal that would make it easy for all small businesses to form retirement plans, the National Employee Savings Trust, or NEST, proposal. The NEST proposal is specifically designed for businesses with fewer than 100 employees. I should mention that we look forward to working with this Committee in further development of that proposal.

In addition to the legislative proposals targeted to small business, because the Administration agrees with you, Mr. Chairman, that small business is vitally important, we regularly issue administrative guidance to assist small business. For example, under current law, taxpayers intending to conduct business in a flow-through partnership must comply with the multi-factor test, which is both complex and uncertain, and requires many lawyers spending a lot of time. And it is a questionable use of resources.

To address this problem, we recently issued a notice suggesting a proposal that would replace the current system with a system that would allow people to just check a box on a return if they

want to be treated as a partnership. If adopted, this check-the-box proposal would replace the current rules, and eliminate the needless burdens. This proposal has been uniformly praised by taxpayers and tax practitioners.

Prior to that, we also issued guidance addressing limited liability companies. Limited liability companies are becoming quite popular now because they combine the flexibility of partnerships with the liability protection of S corporations.

Finally, we have also issued guidance addressing S corporation issues. For example, we recently revoked a 1977 ruling that cast doubt on the ability of S corporations to enter into partnerships. We effectively blessed that, so now they can form partnerships.

Our action addressed many of the issues in the Reform Act. For instance, we make it clear that you can form a partnership with a non-resident alien, or other non-qualifying shareholder.

So, in sum, we share the desires of you, Mr. Chairman, and the other sponsors of the Act, to assist and strengthen small business. And we support the goals of the Reform Act. We believe, however, that it is necessary to ensure that the goals of the legislation are achieved most efficiently, and that the primary beneficiaries will in fact be small business.

In making that determination, we should look at how the tax landscape has evolved since the S Corporation Reform Act began in the early 1990's. For example, as I mentioned earlier, LLC's have been a tremendously popular alternative to S corporations. As of 1995, LLC legislation has been enacted in almost every State, and the proposed check-the-box system is on the horizon.

Now while these developments do not eliminate the need for certain S corporation reforms that would be useful, they do require reassessment of exactly who will benefit from any S corporation proposal. We also want to make sure that we do not add undue complexity to the S corporation regime.

Of course, many of the technical and administrative provisions of the Reform Act are simply good government, and we support them. For example, they include the rules that grant IRS authority to treat flawed elections as valid, and certain other proposals. We also support the proposal to increase the number of shareholders from 35 to 50.

We are concerned, however, that other aspects of the Reform Act, when coupled with current law, will unduly benefit large C corporations, rather than the intended beneficiaries of the Act, small business.

We base our concern on a variety of factors, including the fact that under current law, regular C corporations seeking flow-through treatment can frequently escape most corporate level taxes by simply electing S corporation status, assuming the applicable requirements are met.

In this regard, S corporations have a distinct advantage over other flow-through regimes, such as partnerships. If a C corporation chose to conduct business as a partnership, it would generally incur a corporate level tax. This toll charge is necessary to reduce the erosion of the existing corporate tax base.

We are concerned that one of the consequences of the Reform Act expansion of the eligibility requirements will be to enable an in-

creasing number of large C corporations to avail themselves of the S election to escape corporate level taxes.

We expect that, if the Reform Act becomes law, large C corporations will take advantage of the new rules. The administration believes that legislation intended to benefit only small businesses and existing S corporations should do just that.

In short, the Administration supports the goals of the S corporation reform, but believes it should be more carefully tailored to its objectives and avoid undue complexities.

We would be pleased to work with the Committee to develop an S corporation reform package.

Let me move quickly to the home office deduction, and say that we generally support that proposal. We agree with you, Mr. Chairman, that it is important that the tax law keep pace with changes in the workplace. In light of the realities of today's workplace, the principal place of business requirement for home office deductions, as interpreted by the Supreme Court, is inappropriate in many cases.

So while we believe reform is appropriate, and we generally support it, we do want to caution that there are certain administrability considerations that should be addressed. We have got to make sure we do not turn the clock back to the pre-1976 law that had such a widespread level of ambiguity that there were many disputes.

Finally, we are also concerned about the implications of the home office proposal for commuting expenses. As currently drafted, it would permit deductions for currently non-deductible commuting expenses. We believe the effects of the home office proposal should be limited to home office expenses. This issue, as well as some of our administrability concerns I mentioned, can be addressed through minor drafting revisions.

In summary, we support the home office proposal, and would be pleased to work with the Committee to address the technical concerns.

Mr. Chairman, this concludes my testimony. Sorry I ran over. I will be happy to answer any questions you may have.

Senator HATCH. Well, we appreciate your being here. We also appreciate the support that you have given for both bills. It is somewhat limited on the S corporations but, nevertheless, basically general support for the home office deduction. We appreciate that very much.

As you know, IRS data indicate that there are about 2 million S corporations in the U.S., and that these are growing at about a 7 percent annual rate. So they are growing up pretty fast. Moreover, S corporations make up nearly 50 percent of all corporations, and a much higher percentage of small corporations. So I think you would agree with me that they comprise a very significant segment of today's economy.

Mr. KOHL. Yes, Mr. Chairman, very significant. And, as I mentioned in my testimony, we believe that some reforms are appropriate. The only issue, as I think we all agree, and as indicated in your opening statement, is to help small business. And it just seems that in these times, we should make sure it is carefully targeted there.

There is no limit on how big an S corporation can be, and I am not suggesting that there should be such a limit as there is no limit on how big partnerships can be. But one of the things it means is that we have got to make sure we are targeting it to small business, and I think the ability of C corporations to take advantage of these proposals is very significant.

I think it is only a matter of time before some well-known publicly-traded company gets taken out in a leveraged buyout by a few people and, perhaps with the benefit of these provisions, elects S corporation status, and everyone is going to be stunned. There are S corporations where there are hundreds of millions of dollars. So the only question is, if we want to direct tax benefits to small business, we should just target them precisely.

Senator HATCH. All right. Many of my small business constituents tell me that two of the biggest problems faced by small businesses today are, one, attracting capital to the business and, two, being able to pass the business on to the next generation without having to sell it to pay for the taxes.

Do you agree with me that what we are trying to do are significant changes that will help in both those instances?

Mr. KOHL. Yes I do, Mr. Chairman. In a certain sense they will. But I also think that some things are not fully understood, and it is not just tax.

Before I came to Government a year and a half ago, I practiced in the Silicon Valley, with a large firm where we had, frankly, the lion's share of the market out there, and had significant involvement with many venture capital financings. People would say if we could have some of the provisions in here, we would get more access to venture capital. While in some cases it would be true, I think it is overstated. Let me give you an example. Most venture capital funds are formed as partnerships. Even after the Reform Act, however, a partnership cannot invest in an S corporation. So, even after this Act, you would still not have access to venture capital in those large partnership funds, which is the bulk of the venture capital money.

Similarly, they generally want convertible preferred stock. This bill would not allow convertible preferred stock.

Finally, I would also mention that I have represented both venture capitalists and companies looking for venture capital. People who think that a bank would be less intrusive than a venture capitalist in terms of decision-making, it is just not there. You get a venture capitalist, you get a board member who is not just trying to avoid the downside, he wants to maximize the upside.

And the last thing I will say is that venture capitalists generally invest with a view towards bringing a company public or having it acquired. A business that wants to be kept in the family is not going to want a venture capitalist as a shareholder.

So I agree that we should address these issues. We just want to make sure that it is directed exactly to the benefits that we want to give them, and that people who were not intended to benefit will not benefit from it.

Senator HATCH. Well, I think that is very helpful. With regard to the C corporation issue, would the administration be willing to

send up some language that would be helpful in correcting the bill, or making it a better bill?

Mr. KOHL. Frankly, the Senate Finance Committee has a terrific staff.

Senator HATCH. So, we can do this on our own?

Mr. KOHL. Well, no. I would be glad to meet with them and work out some language.

Senator HATCH. We like you guys from Silicon Valley, I will tell you.

Mr. KOHL. No. I would be happy to work with them on that and some of the other proposals to see if we can get one that we——

Senator HATCH. That would be great, because what we would like to do is come up with a bill that the administration could support. You support much that is in the bill, and it would just be a good thing if we could work together. So, if you will, we would like to see what changes you would like us to make.

On the home office deduction, I have to say that we would appreciate any support we could have on that as well, because we think it is outrageous what the current interpretation really is. So we are going to push that as hard as we possibly can, and overturn that Soliman decision if we can.

Well, thank you for appearing. We appreciate your taking the time——

Oh, I am sorry. Senator Pryor, do you have any questions?

Senator PRYOR. I do not have any questions. In fact, I do not even think I have a statement. I am just real proud that you have held this hearing today, Mr. Chairman, and I am proud to be working with you on this question of Sub S.

Senator HATCH. Vice versa.

Senator PRYOR. It has been a long time in the making, and we have worked with a lot of wonderful groups around this city and this country to bring this legislation out. And I look forward to working with you. I hope we can get it signed into law pretty soon.

Senator HATCH. Thank you, Senator Pryor. We appreciate it. You have been working on this for a long time, and we hope that by working together, we can get it done.

We appreciate any help the administration can give us, all right? Thanks so much for being here.

Mr. KOHL. Thank you for having me.

Senator HATCH. Our next panel will be Mortimer Caplin, Esq., of Caplin and Drysdale, here in Washington, D.C., Wendy C. Gerzog, a professor of Law at the University of Baltimore School of Law in Baltimore, Maryland, Judith Obermayer, Ph.D., chairman, board of directors, of the National Association for the Self-Employed, here in Washington, DC, and Craig Willett, from my own home State of Utah, of Willett and Associates, Provo, Utah, testifying on behalf the National Federation of Independent Business.

We are very happy to have all of you here today. Mr. Caplin, we recognize your great service to our Government through the years, and we are really happy to start off with you.

If you can stay within the time limits, we would appreciate it, because I have to finish within a certain time here today.

[The prepared statement of Mr. Kohl appears in the appendix.]

## STATEMENT OF MORTIMER CAPLIN, ESQ., CAPLIN AND DRYSDALE, WASHINGTON, DC

Mr. CAPLIN. Mr. Chairman, Senator Pryor, my name is Mortimer Caplin. I am a member of the law firm of Caplin and Drysdale, and I served as the U.S. Commissioner of Internal Revenue during the Kennedy and Johnson years. It is always a privilege to be up here.

If this new legislation is to be adopted, the approach of Senator Hatch's S. 327 is highly preferable over H.R. 1215. It is more tightly drawn, and it leaves less wiggle room for manipulation in its use.

The home office issue has had a turbulent and unsettled history, mostly due to the mixed character of the deduction, which is both personal and business. We have to differentiate between two provisions of the Code. One is section 262, which disallows deductions for personal, living or family expenses. Within this category are items such as food, clothing, home, travel and entertainment which, for the average citizen is his or her nondeductible personal responsibility.

In contrast, we have section 162, allowing deductions for all ordinary and necessary expenses paid or incurred in carrying on a trade or business.

Between these two opposite poles, how then do we treat expenditures possessing combined elements of each—a given degree of personal use, balanced with some measure of valid business use?

And what about the blatant tax avoidance when the expense is in fact overwhelmingly personal, yet can easily be disguised with a purported business mantle? Or when, at very little marginal cost, a small degree of bona fide business use is combined with clearly dominant personal use?

Use of an improper classification not only brings direct revenue losses but, perhaps more important, particularly when generally known and broadly used as this is, stokes public resentment, undermines taxpayer confidence about the fairness of our tax system, and discourages accurate self-reporting.

It is these same overlapping characteristics of personal and business which led to the post-World War II infamous era of expense account living, generally referred to as T&E, or travel and entertainment deduction. "It is deductible," was the battle cry of the day—and I certainly lived through it in the 1960's.

The widely publicized reports of lavish and excessive use of T&E brought heated public criticism. Finally, in 1962, the Congress took steps to restrain these practices by adopting a whole series of disallowance provisions.

Very comparable to these T&E abuses was the well known home office ploy—claiming tax deductions for essentially personal expenditures, layered with a thin veneer of business coating. With a desk, cabinet and a lamp, just about every Tom, Dick or Harriet was at the quick to claim a tax deduction. And so they did, with IRS agents assigned the difficult and intrusive task of sifting through mounds of facts, attempting to separate the wheat from the chaff. In 1976, Congress put a badly-needed halt to these excesses when they enacted Code section 280A, imposing tight limitations on home office deductions. Only by this legislation was a nagging measure of tax avoidance eliminated.

Today, if any loosening takes place, it should be done with a full understanding of other tax implications. As Supreme Court Justice Robert Jackson once said, taxation is a "field beset with invisible boomerangs."

One consequence of expanding the home office definition is its direct impact on run-of-the-mill commuting expenses that the Treasury just mentioned. For most taxpayers, costs of traveling from home to work, including parking, are personal and nondeductible. In contrast, travel between two places of business or employment—and again including parking—fall into the deduction category.

What then if your home is to be allowed to be designated as your principal place of business, and you still commute daily to a regular downtown business location? How much do you entice taxpayers to strain for such beneficial categorization? What is the revenue cost?

In drafting the statute, it would be helpful to clarify the quantum of time required to be spent in the home office, to consider giving Treasury specific regulatory authority to elaborate on the meaning of some of the terminology, and to make it clear that the new standard has no applicability to the commuting expense, which should be addressed in the future after further study.

As Congress goes down a rocky road, seeking a glide path to a balanced budget, it must first ask itself the question, how far do you want to reopen the door? Indeed, there are categories of taxpayers, such as consultants, musicians, authors, others engaged in creative work, who may not satisfy the proposed requirement for essential administrative or management activities. However, in doing creative work, they may have an even more compelling case for statutory relief.

Finally, before the Committee goes forward, I suggest that the advice of the IRS be asked about this. They have been exposed to a lot of practical problems encountered in the past, and IRS views on the statutory terminology itself, or its administrability, would be very important.

After all, it is the IRS who, for the taxpayers of America, will have to prepare the form 1040 to reflect your ultimate legislative judgment.

I will be very happy to answer any questions.

Senator HATCH. Thank you so much, Mr. Caplin.

Dr. Gerzog, we will go to you next.

[The prepared statement of Mr. Caplin appears in the appendix.]

**STATEMENT OF WENDY C. GERZOG, Ph.D., PROFESSOR OF LAW, UNIVERSITY OF BALTIMORE SCHOOL OF LAW, BALTIMORE, MD**

Dr. GERZOG. Mr. Chairman, Senator Pryor, I thank you for allowing me the opportunity to express my concerns about the proposed home office deduction amendment.

I have five major objections to the proposed amendment. One, since this is an all or nothing deduction, a relatively few hours of business use by the taxpayer will allow that taxpayer the same full deduction as another taxpayer who has a truly home-based business. If a taxpayer's business has a small administrative component, as long as it is regularly carried on, even for a few minutes

or an hour each day, the taxpayer is entitled to a full deduction, the same as someone working 40 hours a week at home.

Two, the bill will allow taxpayers to deduct commuting expenses. Generally, commuting expenses are nondeductible personal expenses. Indeed, if they were deductible, you would be rewarding most those people who worked farthest away from their main job site. And that would not make very much sense.

Usually the drive from one's home to office number one is nondeductible commuting. The drive from office number one to office number two is deductible business transportation expense. Once you classify one's home as a home office, essentially that home becomes office number one, so that that taxpayer is able to make her commute a deductible one.

Imagine, the taxpayer gets up, has breakfast, does a little billing, goes in to work, comes home, has dinner, does a little more billing, and then goes to sleep. She will have sweet dreams because, unlike most of the workers in this country, she will be able to make her commute a deductible one.

A member of the Joint Committee staff told me that in their revenue estimates they estimated that, at most, 15 to 20 percent was allocated to these increased business transportation costs. It seems to me that that is a very low estimate. Indeed, it does not seem to comport with public perception, the numbers seen in case law, or in the depreciation allowance itself.

For example, Ellen Katz of the National Taxpayers Union was quoted as stating that limiting the deductibility of business auto expenses would cost work at home taxpayers more money than losing the home office deduction.

In case law, for example, in 1983, Dr. Soliman took a $1,200 deduction with respect to the home office, and then approximately a $3,700 deduction with respect to his Buick. Also, it is more likely that car depreciation expenses will be larger since cars can be much more rapidly depreciated than a building, even with the 1984 and 1986 amendments.

Three, it makes no sense to add a tax deduction which will rarely affect a taxpayer's behavior. Most taxpayers work at home for their own convenience. And most wealthy taxpayers have a study in their homes, regardless of its deductibility.

Moreover, Congress enacted section 280A in order to prevent taxpayers from converting personal expenses into deductible business expenses, particularly where they have incurred little additional cost. The proposed amendment thus runs contrary to the goal of the disallowance section. Four, rather than simplify the Tax Code—which I know is a priority of this Committee—this amendment will add more complexity to the tax laws. It offers yet another new test for the courts to interpret in potentially conflicting ways.

Indeed, where a taxpayer's business has a small administrative component, it is unclear exactly how minimally a taxpayer can use her study, and still be able to deduct it.

Five, this provision invites fraud and abuse. Because of the minimal use requirements, it will be so tempting for a taxpayer to say that she only uses her home office to do business for those few hours a week, and never uses it for any other personal or family purposes.

Essentially, it is hard to imagine how such minimal use of a home office could be verified. Given privacy concerns and the large numbers of taxpayers who will claim the deduction, it will be difficult to administer and enforce.

In sum, the proposed home office deduction is likely to generate a revenue loss. Yet it is questionable whether the provision is worth it. A few hours of business use will allow a taxpayer the same deduction as the taxpayer with a truly home-based business. Much additional revenue will be lost by allowing taxpayers to convert personal nondeductible commuting expenses into deductible transportation expenses.

Few, if any, taxpayers will change their behavior because of it. It will add to the complexity of the Tax Code. It will encourage taxpayer cheating. And it will be difficult to enforce.

Thank you.

Senator HATCH. Thank you. We will turn to you, Dr. Obermayer.

[The prepared statement of Dr. Gerzog appears in the appendix.]

**STATEMENT OF JUDITH OBERMAYER, Ph.D., CHAIRMAN, BOARD OF DIRECTORS, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED, WASHINGTON, DC**

Dr. OBERMAYER. Thank you, Chairman Hatch, Senator Pryor. Thank you for inviting me to come here to testify.

I am the owner of a home-based business in Massachusetts. I do consulting out of my home. And I am testifying as chairman of the National Association for the Self-Employed.

I also have been serving as the chair of the Massachusetts delegation to the White House Conference on Small Business, which concluded last week. Nearly 2,000 small business owners from all 50 States served as delegates. Home office deduction reform is one of the major policy recommendations adopted by the conference.

I am testifying in favor of S. 327, which seeks to negate a recent Supreme Court decision, which you discussed earlier, which basically severely restricts the ability of many home-based businesses to take any deduction for a home office.

One of the concerns has to do with how many people this affects, and there are a lot of people. The SBA estimates that there are something like 7 million home-based businesses in the United States, of which 2.8 million are operated by women.

The National Association for the Self-Employed has over 320,000 members. We estimate, first of all, that 85 percent have 5 or fewer employees. We are talking in general about very small businesses. And we estimate that 65 percent of our members operate home-based businesses.

In most cases, these businesses are very small and struggling businesses, where any deduction loss goes straight to the bottom line. Businesses that rent an office down the street can deduct that without any problem. For the vast majority of home-based businesses, we have now effectively taken away the ability to deduct their own office in their home.

There already were restrictions that said you had to use it exclusively for your business. We are not taking exception to those restrictions. However, what we really want is, if you have a legiti-

mate office in your home that is used for that purpose, it should be a deductible expense.

There has actually been an enormous trend toward home-based business in recent years. Economic changes have had a profound impact on the nature of business today. Women have found home-based businesses of particular advantage as an important way to start, partly because it is not expensive to start, and partly because it allows for a lot of flexibility in terms of family responsibilities. Some are women hitting the glass ceiling in the corporate world, and they go out on their own. Others find that the corporate world is unfriendly in terms of family policies, and going out on their own is the best way they have of compensating for that.

We also have other things happening. In my own State of Massachusetts, we have seen cutbacks in defense, competition from abroad, and from smaller, leaner companies at home, downsizing and reengineering of many previously successful large corporations in areas like computer hardware, financial services and health care. The result is many fewer jobs in the large corporations.

It is also particularly difficult for people over 50 who lose corporate jobs. Often they have little likelihood of future corporate employment.

For those with professional skills, or with technical ideas for new products, one of the most obvious and easiest options is to start a business. And, almost inevitably, those businesses start at home. I have seen it happen when bases closed.

And we have also seen that technology has pushed that even further. Senator Hatch, you talked about the change to working at home. Between the computer, the fax, the modem and the copier machine, you can set up an office fairly easily, and fairly inexpensively. And you can set up a business without a large investment.

So there is a whole trend going in that direction. I believe the trend is good for the economy. I think we are seeing companies start, and people going out and working who might not be able to do as well in some other environments. And we are seeing a lot of economic development coming out of it. The new jobs are all coming out of companies with 1 to 5 employees.

The trend should absolutely be encouraged, and we should be creating a level playing field. If you can deduct rent down the street, you should be able to get a reasonable deduction for home office costs.

I would disagree that people use their house, and then have another office someplace else. Most of the people that I know who are home-based do not have a second place of employment that they are going back and forth to. That is not the way it is on the street, from my experience.

In conclusion, I would like to say that the National Association for the Self-Employed strongly supports the home office deduction provisions of S. 327. We look forward to working with the Senate Finance Committee to ensure enactment of these important provisions for small business.

Thank you.

Senator HATCH. Thank you.

Mr. Willett, we will go to you now.

[The prepared statement of Dr. Obermayer appears in the appendix.]

**STATEMENT OF CRAIG WILLETT, WILLETT & ASSOCIATES, PROVO, UT**

Mr. WILLETT. Thank you, Mr. Chairman. I would particularly like to thank you, as one of my Senators, for the invitation to appear here today, and Senator Pryor also.

I am submitting this testimony on behalf of the National Federation of Independent Business. My name is Craig Willett, and I am a small business owner and CPA from Provo, Utah. I have a Masters degree in taxation, and my practice primarily centers around tax compliance, tax planning, tax strategy and IRS representation. I also serve on the board of several corporations, and on the board of a community bank.

I have enjoyed the opportunity to testify in Congress several times over the last several years. Most recently, I served with Dr. Obermayer as a delegate to the White House Conference on Small Business, as the vice-chairman from the State of Utah.

As she indicated, the conference concluded last Thursday, and the home office deduction was ranked one of the top priority issues of the conference—ranked number 20 out of the top 60 issues.

As you mentioned in your opening remarks, Mr. Chairman, with the changes in the economy over the last 5 years, corporate America has downsized. This downsizing has greatly benefited my tax and advisory service business. Many people have left the employment of large corporations, and have started businesses out of their homes.

Primarily, they are able to do this because of the technological advances made today. They are able to outfit their offices with computers and fax machines, with which they can perform essential full-scale office functions. Some of these people have been discriminated against with the Tax Code.

Section 280A of the Internal Revenue Code requires taxpayers wishing to use a home office to use a portion of their home exclusively for business. In addition, the office must be the principal place of business, the place used by clients or customers, or a separate structure on the same property as the home.

The major part of the conflict between the Internal Revenue Service and taxpayers stems from the argument of what constitutes a "principal place of business".

Section 280A was enacted by Congress to establish a less subjective, uniform standard for determining which offices qualify for the home office deduction. Despite this effort, different courts in different jurisdictions began establishing their own tests to determine whether an office was qualified. The phrase "principal place of business" was the basis for much of this dispute.

Some courts adopted a "focal point" test, which looked at where services are provided, and from which income was generated. This test proved to be too narrow, so some courts adopted a "dominant portion of work" test to replace it. This new test would only require that businesses perform a dominant portion of the activity at the home office.

Then the U.S. Tax Court rejected the focal point test and the other tests, and adopted one of its own, leaving taxpayers even more confused. Under the tax court test, the court looked at the facts and circumstances in each case to determine whether or not a home office was eligible for the deduction by examining (1) if the office was essential to the business; (2) if the office was used for a substantial amount of time; and (3) if there were other locations where this work could be done. Once again, this test was eliminated by the Supreme Court in 1993 in the Soliman decision.

In 1993, the Soliman decision involved an anesthesiologist who had patients he visited to perform surgery at hospitals, but he maintained necessary paperwork, such as billings, paying his bills, storing documents, and studying for his anesthesia procedures. The court, through its use of the plain English definition of the word "principal", held that the hospital was Dr. Soliman's place of business.

It seems to me that the court missed the point. This is what is causing most small business owners to be up in arms with the Soliman decision. Dr. Soliman may use the hospital to perform surgery and follow up with patients, but how can he earn a living if he cannot perform essential, vital business functions, such as billing and paying his own bills as a responsible business owner?

Most of the confusion over the home office is caused by the phrase "principal place of business". The Supreme Court read the statute literally, and came to the conclusion that a taxpayer can have only one principal place of business. And this place of business is determined by the importance of the activities performed at each location, and how much time is spent at each location.

In other words, this location must be where most of the business activity takes place. It is possible for taxpayers to have no principal place of business.

Maintaining the current law under Soliman would be another blow by the tax system for the self-employed, in addition to such actions as the self-employed health insurance deduction. By the way, I do want to commend this Committee and the Senate for making the health insurance deduction permanent at 30 percent, and taking a step forward, although it is not quite enough yet.

My firm currently maintains a client base of over 800 clients. Of these clients, the majority are small or closely-held business owners. Under Soliman, only 2 percent of these clients are able to qualify for the home office deduction.

Under the proposed changes in S. 327, an additional 15 to 20 percent will qualify. The following are some examples of actual clients who have been hurt by the Soliman decision, and who would benefit from S. 327.

One of my clients is a general contractor, not one who rides around in a Mercedes-Benz, and inspects large buildings, but gets out with his hammer and nails every day, and frames the homes that he builds. In so doing, he pays his bill, stores his plans, maintains the governmental records he is required to have, W–4 forms, W–2 forms, and the requirements he has to meet in his home office.

He took the deduction on his 1991 return, and his return was selected for audit before the Soliman decision. Between the time he

was selected for audit and the audit conference, the Soliman decision was handed down.

My client was judged based on the Soliman decision, with all the confusion going on, when he was relying on the tax court rules. In the audit, my client lost the deduction, and it cost him over $2,000 in taxes because of the Soliman decision.

Some of my clients are also management consultants who use their home offices to prepare their documents, their presentations and videotapes, their training manuals. They then leave their offices and travel outside of the State of Utah to conduct training seminars for large corporations in this country.

I feel that limiting the deduction to the amount of time used in the office is severely restrictive for most taxpayers who are legitimate business owners, and who need to have an office to centrally locate and efficiently run their businesses.

With this proposal, the clients that I have mentioned, as well as many other small business owners, would be afforded a much needed deduction for maintaining a home office. I am in support of this proposal, and I believe it is a step toward a Tax Code less discriminatory against the self-employed taxpayer.

I am pleased that the Finance Committee was willing to have a hearing on this key important issue.

Thank you.

Senator HATCH. Well, thank you, Mr. Willett. We appreciate your being here, and all of you.

[The prepared statement of Mr. Willett appears in the appendix.]

Senator HATCH. Senator Pryor, do you have any questions?

Senator PRYOR. No, I do not.

Senator HATCH. Well, let me just ask one or two. I am really happy to work with Senator Pryor on these issues. He is a very fine leader here in the Senate, who has been working on these for a long time, and I hope we can make some headway.

Mr. Caplin, do you feel that the Soliman decision has hurt self-employed Americans, or is it intended to weed out those with weak home office claims?

Mr. CAPLIN. That is a very tough decision. Soliman probably contains an ideal set of facts for the taxpayer to illustrate the tightness of the present rule. I think there is room for some liberality, and all my testimony really was saying is for you all to move cautiously here in granting some measure of relief.

There may be 7 million self-employed, but there are 110 million tax returns being filed. And the temptation for people to try to fit into this home-office mold is overwhelming. It is so easy to do a little bit of administrative work. That is why I suggested that there be a quantum of business work test of some sort in the statute. It is a question of priorities. Where do you want to loosen the rules? One can point to many places in the Code where you might want to give relief.

Senator HATCH. Well, you pointed out the language in S. 327 is somewhat narrower than in the House bill.

Mr. CAPLIN. Yes. There is a little heavier emphasis on the amount of time that has to be spent, not incidental. For example, this issue came up in the passive loss rules, so far as real estate

is concerned. And there are some very difficult definitional problems, too.

In that statute, the IRS was given a lot of room to adopt regulations—legislative regulations—to define what one meant about something like "primarily" and not "incidental". They came up with an hourly test, in terms of the amount of time you have to spend on real estate.

Similarly, I think this ought to be approached in the same fashion.

Senator HATCH. You mentioned in your testimony that you are concerned that, if the home is allowed to be designated as the principal place of business, taxpayers might still commute to a regular downtown business office, and deduct travel expense.

But the language in S. 327, where it provides that, "there be no other location for the performance of the essential administrative or management activities of the business", does that not effectively prevent having two principal places of business and thus eliminate an improper commuting deduction?

Mr. CAPLIN. Well, there might be another office you go to, where you do not do your administrative work. You do all your administrative work at home, but you still go to this other office downtown. In other words, I might prepare for my day as a lawyer back home, and I might even to tempted to do some billing from my home, if I wanted to fit into this pattern. So I think it would be helpful if you required a certain significant amount of time to be spent at home to qualify.

I think the potential for abuse is pretty widespread. And all I am urging is that you consult with the IRS about it. They have a lot of experience in this area.

Senator HATCH. Sure.

Let me go to you, Dr. Gerzog. Do you think that the current tax law treatment for home offices is appropriate? I know you testified against the bill here today, but would you stick with the current law, or would you make some changes?

Dr. GERZOG. I think, if I had my total preference and freedom to choose anything, it would be to eliminate the principal place of business exception, and to substitute in its stead where it is the taxpayer's sole, fixed business location. It seems to me that it would cover a lot of these small business concerns, and it would take some of the ambiguities out of the current provision.

But, given the choice of the current law versus the proposed amendment, I would prefer the current law.

Senator HATCH. Well, our major objective in introducing S. 327 was to overturn the Soliman decision, and try to restore the tax law as it was before the Supreme Court ruled in that case, even though I realize that this law was far from perfect.

Recognizing the phenomenal growth in the number of Americans who are starting home-based businesses, do you not believe that the Internal Revenue Code should allow these entrepreneurs to deduct their legitimate business expenses?

Dr. GERZOG. I agree with Mr. Caplin in saying that this statute is just too broad. The proposed amendment is just too broad, and it would cover a lot more situations than someone who truly has a home-based business.

I think, even under current law, someone who has a truly home-based business is currently able to deduct it.

The language is too unclear. There needs to be some sort of minimal use provision or requirement, so that there will not be such an incredible proliferation of just about every taxpayer seeking to deduct a home office.

Senator HATCH. Thank you.

Dr. Obermayer, you have indicated that you think that the changes we are making would be very beneficial. What types of individuals and their businesses have been especially hurt by the Soliman decision?

Dr. OBERMAYER. Well, some of the people I think of right away, besides contractors that were mentioned earlier, who often do all of their work outside, but have to prepare bids, quotes, billings and everything else in an office somewhere, there are a lot of people who are independent sales representatives for, say, pharmaceutical companies and things like that.

They usually carry more than one line, so they are not normally an employee of a corporation. They are literally independent business representatives. They have to do all their paperwork and keep their samples in a place which is frequently a home office. They are affected by this decision because their sales are not in the office. Everything they do is outside, in terms of where the economic activity of the business actually occurs.

According to the way the Supreme Court ruling went, they would not be eligible for the home office deduction in that case.

Senator HATCH. Now you indicated that, of the over 5 million women business owners in the United States, 55 percent of them work from within their homes.

Dr. OBERMAYER. The statistics I have from the SBA say that 2.8 million work in home-based businesses. This may or may not be their own home. A home-based business also will have employees. They may, however, not be allowed to have any customer come to their home because of zoning laws. There is more than one thing that happens when you set up a home-based business. In many locations, they can operate business activities, but they cannot really have customers come, or they will be violating zoning laws.

Senator HATCH. The point I am trying to get to is how has the ability to work in the home, as opposed to the office or other workplace, benefited women in our society?

Dr. OBERMAYER. Well, I think one of the most important things is that you have a lot of people trying to have flexible hours. And a lot of the women who work at home end up doing a lot of their business not in the 9-to-5 time frame because they are trying to work around family needs.

It does not mean that they do not use the office for significant periods of time, but it may be 9:00 p.m. to midnight, rather than 3:00 to 6:00 in the afternoon. It does give them a lot of flexibility that way, in terms of family responsibilities.

And it is not, in fact, just the women who do that. In many families, the woman is going out and the man is doing work from the house. It depends on the occupation as to what is appropriate. For instance, journalists, graphic designers and people like that find

that they also can work flexible hours out of the home. And it is not just the women who do that.

Senator HATCH. Well, some of the people who are critical of what we are trying to do here have characterized the home office deduction as a tax benefit for the wealthy. I am wondering if your group believes this to be the case, and who are some of the typical entrepreneurs who might benefit from this type of legislation?

Dr. OBERMAYER. Certainly from the people I know about, we are often talking about very marginal businesses. By the way, the deduction is usually fairly small. We are not talking about a large amount of money in general. But, even if they could rent space, it is more expensive to do that than to take the deduction. The deduction is nowhere near as much as it would cost them to rent space outside. So some of it really has to do with keeping costs down, as well as some of these other flexibility issues.

People start out in the home. If the business really starts to boom, and they need more employees, then they tend to move out to a larger location. We are really talking about early stage, and very small businesses. I cannot say that no wealthy people use it. I would not venture to say that. But I think that, by and large, from the statistics I have, that it is really quite small businesses that use this kind of deduction.

None of us are talking against some safeguards to prevent people going into large loopholes, when it does not really make sense. But I think, if you look carefully at the kind of people who use these kinds of deductions, this Soliman decision really took a lot of people out of the ability to use that deduction.

People say that all sorts of people use it. I have been warned by my own accountant, and told about experiences of other people. People are told by their accountants to be very careful about even trying to use this deduction unless they are really sure that they fit the rules. It is a red flag as far as the IRS agents are concerned, and we all know it.

Senator HATCH. You indicated in your testimony that S. 327 would permit salespeople to deduct the costs of storing their samples in their homes.

Dr. OBERMAYER. I am not sure if that is true of this version. It was in the House bill, I believe. I do not know if it is in the Senate bill.

Senator HATCH. Well, whichever version it is in, how important would that provision be?

Dr. OBERMAYER. For those people who are in the kind of sales businesses where they must keep extensive samples, it is extremely important. I think that is a much smaller group of people. But, for those people for whom it is relevant, I think it is very important.

Senator HATCH. Are most of the people who are members of your group, who work from their homes, engaged in high-tech occupations?

Dr. OBERMAYER. Probably not. Probably most of them are small service businesses, contractors, and that sort of thing.

I certainly know high-tech people, and a lot of them start that way. But I suppose that people like system engineers, and people like that, who do consulting in these fields, are very often home-based.

But when those actually get to the point of manufacturing, it is not normally home-based any more.

Senator HATCH. All right.

Mr. Willett?

Mr. CAPLIN. Senator, I just wanted to mention——

Senator HATCH. Yes. Go ahead.

Mr. CAPLIN. Dr. Obermayer had some very legitimate types of cases. But the point I am trying to make is that this is an area of great potential abuse, affecting tens of millions of taxpayers. And this is the same thing we had with travel and entertainment. A lot of entertainment is not truly business motivated, but one is able to enjoy the largesse of life and still be able to get a deduction, while the other man down the street pays with hard-earned non-deductible dollars. Here, at very little marginal cost, some sizeable deductions can be created.

Maybe the approach ought to be to take into account that these small marginal costs set the stage for getting big benefits; and maybe you ought to have a percentage approach, like you do on entertainment expenses. Only a given percentage of these expenses are deductible, to take full recognition of the fact that you are going to have the house anyway, and a lot of those charges are paying for your personal expenses.

Senator HATCH. All right.

Mr. Willett, let me just ask you a couple of questions. In your practice, have you seen a lot of abuse of the home office deduction by taxpayers?

Mr. WILLETT. No, I have not. And I am kind of taken aback by the accusation that there will be abuse with this. It is sort of like, as a small business owner, and self-employed, you feel that you are in the minority.

It is sort of the in thing now to be in small business, and we are finally getting some respect. But I do not see why we should be suffering a disadvantage because of a few people who represent the majority may push the system a little bit, and qualify for a home office.

I think what you have to look at is how many people are trying to start a new business, write a new software package, start a new computer company, build houses for their neighbors, and they are not entitled to the deduction that other people are entitled to, and they should be, because it is a true cost of doing business. And I think we need to look at what those true costs are, and then not scale it back. Give them the full benefit of those costs they can prove are actually business expenses that they incur.

Senator HATCH. Dr. Gerzog and Mr. Caplin both mentioned the possibility that the Home Office Deduction Act could lead to commuting expenses becoming deductible, and thus leading to a great deal of revenue loss to the Treasury. What is your view on those statements?

Mr. WILLETT. I have two views on that. The first one is that some of those people—the general contractor I mentioned in my testimony—is not able to take the home office deduction. Whether he is entitled to take commuting expenses once he leaves his home, which cannot be his office, you take the deduction entirely away from him now, if you qualify a home office as a prerequisite to get-

ting a commuting expense when you get to a second location. But his location is each house he is building. When he leaves his home, he gears up his truck and takes his tools with him. I think that type of person should be entitled to that.

I do not see the majority of people among my client base having a downtown office, and looking for reasons to sit home and do a little bit of work, to be able to deduct their home. These people who are being affected by the Soliman decision are people who have legitimate businesses but, because they do not spend 50 percent or more of their time in their home office because of the nature of their work, are not entitled to the deduction.

People who do training go to off-site, remote locations. They need the deduction to maintain that office. They cannot spend 50 percent or more of their time in the office, but the office is still essential to the revenue production.

Senator HATCH. You mentioned in your testimony that many of your clients have been denied a deduction for legitimate home office expenses. How much more do you estimate that your clients pay in taxes, as a result of the Soliman decision? Is there some way of estimating that?

Mr. WILLETT. When the Soliman decision came down, and they came to my office to discuss what their tax liability could be or is going to be, they know when it goes up. Most of them experienced between $200 and $2,000. Two thousand is probably on the higher end because it was a significant portion of the home. But between $200 and $2,000 is the additional cost that they have had to pay.

Senator HATCH. You mentioned that self-employed individuals are discriminated against by our current Tax Code. In your view, what are some of the ways that the current Tax Code discriminates against individual entrepreneurs?

Mr. WILLETT. Well, the first one that comes to mind, as I mentioned in my testimony, is the self-employed health insurance deduction. That is one of the major costs when you have a service-based business, you have employees, and you want to provide them benefits. You provide it for them but, by being self-employed, your family suffers by paying a higher cost for your insurance because you are not able to deduct the other 70 percent. That seems to be unfair. The reason that I often hear when I come back to Washington is, gee, it is going to cost so much money.

I am not looking particularly to carve something out for myself. I am just asking to be treated like the other 110 million taxpayers who get the full deduction, or get to exclude it from their income. Be fair about it. If we are going to offer the deduction, then grant it to everybody, regardless of their class in the business rankings.

So I think that is one, and the home office is the other area where they have been extremely disadvantaged since the Soliman ruling.

Senator HATCH. Well, you also indicated in your testimony that there is a lot of uncertainty over how to interpret the IRS rules regarding home office deductions. Would this bill, S. 327, help you in that regard?

Mr. WILLETT. I think so. As was testified here earlier, section 280A was supposed to take it from a real subjective test to a more narrow test. I think it did that, but then the courts went even far-

ther, and kept changing the test. I can tell you, as a tax practitioner, we were all over the board trying to advise clients every time a new ruling came out. To rely on a focal point test, a facts and circumstances test, and now a majority of the time has to be spent in that location, does not fit everybody.

I think S. 327 takes another step toward clarifying 280A, and taking a step backwards from where I think the Supreme Court got off track when they went too far by saying that you have to do a measurement test.

Granted, I do not think an anesthesiologist is a good measure of a case. I would rather have seen something more along the lines of my client, being a general contractor, or somebody else who does management training, where the distinction can be more clear, and maybe more representative of the issue.

Senator HATCH. I want to thank all of you for appearing here today.

I would like you to look at this bill, give it some thought, and give us any suggestions you have that might make it better. We just appreciate whatever expertise you have. Of course we will consult with the IRS, and with others as well, but we would appreciate it. All of you have had extensive experience in this area, some from a practical standpoint, others like you, Mr. Caplin, from running the show back there.

Mr. CAPLIN. Senator, I want to say that I visited Ogden, Utah one time, where perhaps the best IRS Service Center is located.

Senator HATCH. And we agree with that, I will tell you. [Laughter.]

Mr. CAPLIN. At one time, there was an effort to move that Service Center. But, after going out there, and seeing the record of the people out there, there was no way that it was going to be moved.

And I know Mr. Willett must have some very fine clients of the same sort. A lot of these clients of his are still getting deductions for their business equipment, and out-of-pocket telephone calls and the like. They are not being denied all business expenses.

Mr. WILLETT. Right. That is why I said that the costs were somewhere between $200 and $2,000, if they were denied all. And I did not mean to imply that at all.

But, on the same kind, I think moving to a test of quantity or quantum of time is not correct, and is not a good measure that we are dictating a percentage of time. Because then we are trying to make everybody fit into the same category. And I think our economy is very diverse. That is what America is about. When we try to put everybody in one category, we end up leaving quite a few people off to the side, and I think we need to try to make it as universally applicable as possible.

Senator HATCH. I think you heard some of these arguments when you were IRS Commissioner. [Laughter.]

Mr. CAPLIN. Time and time again.

Senator HATCH. I want you to know that we in Utah are not yokels.

Mr. CAPLIN. I know.

Senator HATCH. We just won the 2002 Winter Olympic bid.

Mr. CAPLIN. I know. I was there.

Senator HATCH. So we appreciate all of you.

Senator PRYOR. Can I ask one question?

Senator HATCH. Sure. I am sorry.

Senator PRYOR. Mr. Willett, do you have any figures as to how many of the NFIB members, not only in your State of Utah, but perhaps in the other 49 States, operate their businesses from their homes? Do you have any figure on that? If you do not, could you provide it for the record? I think that would be extremely useful.

Mr. WILLETT. We would be happy to get that information.

Senator PRYOR. I thank you.

Senator HATCH. I want to thank you for being here. I know it is a long trip back here, but I am glad you were on that small business group.

All of you have been beneficial to the Committee this afternoon, and we really appreciate it. I have to say that I have to look at the people who are actually in the field, working with these problems, like Dr. Obermayer and Mr. Willett, but we are not going to ignore what you have said, Dr. Gerzog, and certainly not what you have said, Mr. Caplin.

Of course, I have to say that I long for those days of John F. Kennedy, when we were cutting taxes rather than raising them.

Mr. CAPLIN. We tried hard.

Senator HATCH. Thank you so much for being with us today.

Our next panel will consist of Bradley Barney, president of Barney Trucking Company, from Salina, UT, testifying on behalf of the S Corporation Reform Project, Martin D. Ginsburg, professor of Law at Georgetown University Law Center, Dr. Susan Pace Hamill, assistance professor of law at the University of Alabama School of Law, and Samuel P. Starr, a member of the tax executive committee of the American Institute of Certified Public Accountants.

So we will begin with Bradley Barney, who runs his own trucking company in Salina, UT. Mr. Barney, I am proud to have you here from Salina, and I appreciate you as a fellow Utahan coming back here to testify on this matter. So we will turn the time over to you.

If each of you could watch these lights, I would appreciate it.

## STATEMENT OF BRADLEY BARNEY, PRESIDENT, BARNEY TRUCKING COMPANY, SALINA, UT

Mr. BARNEY. Thank you, Senator. My name is Brad Barney, and I am the president of Barney Trucking, Inc., located in Salina, UT. I am also a member of the S Corporation Reform Project. I am joined here today by Kim Robinson, president of Robinson Transport, Lynn M. Carlson and Mona Carlson of Lynn M. Carlson and Company.

This is our first time to Washington, DC. We have traveled here at our own expense, and taken time away from our businesses to try to express our views on this important legislation, and how it is going to affect our businesses in the future.

I would like to thank Senator Hatch, his esteemed colleague, Senator David Pryor, and this subcommittee for their leadership and support of American business.

The S Corporation Reform Act of 1995, which Senators Hatch and Pryor have recently introduced, would vastly improve our abil-

ity to do business as owners and operators, and access capital to expand our businesses.

Barney Trucking is a major hauler of bulk commodities. Our company has grown from the time 50 years ago when my Dad owned one truck, and used to wait up at the coal mines, sometimes for a day or two with a sack lunch, to get a load of coal, to our present fleet today of approximately 70 trucks.

Our company is presently limited to three sources of funding—the owners, the revenue generated by the company, and some bank debt. Our company's initial capitalization was made up of my father's savings, all that he could borrow, and secured by everything he owned.

Today, we are in far better shape. Today we have 123 employees at facilities mainly in Sierra County, Utah, some in Salt Lake, and a few in Nevada. Our company's future, and that of our next generation, depend on improved capital access. Even now, during times of historically low interest rates, we are paying as much as 9-1/2 percent on borrowed funds that we have to secure 100 percent by our equipment. We also have to guarantee these loans personally.

The S Corporation Reform Act specifically addresses capital restrictions by permitting S corporations to have preferred stock, convertible debt and other options available.

This bill would also allow us to set up employee stock ownership plans, which is an ideal way to give key employees and good workers an opportunity to reap the benefits of their work. This would also provide another source of internal capital to our business.

The S corporation reform would permit multiple beneficiary trusts, which permits S corporations to have ESOP's. And it would also allow for easier transfer of ownership of the company to future generations.

Also, because of the massive tax increase last year, for the first time in more than a decade, our company was forced to incur long-term debt to purchase equipment necessary for our normal operations. In practical terms, that means the additional funds that we paid for taxes were simply not available to reinvest in our company. That occurred for us in 1994.

If this legislation could help free up other sources of capital, this would be very important to us, especially in the aftermath of the tax increase.

The legislation introduced by Senators Hatch and Pryor, which is already cosponsored by a solidly bipartisan group of 29, would positively address all of the issues I have raised today. It would open up important alternative sources of private capital for us. It would allow us to have ESOP's, which will give us better long-term help from our employees.

I would also like to recognize that this Congress considers itself pro-business. I am grateful for that support. But the Hatch-Pryor bill is not simply pro-business; it is also pro-labor. By simplifying troublesome estate planning complexities, it is also pro-family, and we are very interested in that.

I would like to thank the Chairman for his work in supporting Utah and its business owners, for working hard for S corporation reform.

Thank you for this opportunity to testify. I would be pleased to answer any questions.

Senator HATCH. Well, thank you, Mr. Barney. I appreciate it.

Mr. Ginsburg, we are honored to have you here. Please give my best to your wife.

[The prepared statement of Mr. Barney appears in the appendix.]

## STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Professor GINSBURG. Thank you, Senator. She stays away from taxes.

Senator HATCH. And we are watching very carefully to see what does happen.

Professor GINSBURG. Mr. Chairman, Senator Pryor, Subchapter S is, on balance, one of the more satisfactory segments of our unsatisfactory tax law—not great, but better than much of the rest.

The S corporation regime has produced, over now 37 years, a remarkably low level of tax controversy. I believe this is attributable in part to the notion that Subchapter S expresses. A single tax or pass-through regime makes good sense. And, in larger measure it is attributable to a trade-off that Congress endorsed and has adhered to from the outset.

It is that the flexibility of special allocations, the precision of disguised sale and hot asset rules, which are hallmarks of the Subchapter K partnership tax regime, are traded away in Subchapter S, and exchanged for a simplified system in which there are no special allocation rules, and in which the complexities that inevitably accompany tax exempt and foreign investors so far have been avoided entirely.

The limited liability company, taxed as a partnership, is a grand and useful innovation but, so long as we maintain a corporate tax system, S corporations will be with us in great numbers. Simply put, as Glen Kohl indicated earlier, a new enterprise can organize as an LLC, but an existing corporation cannot shift to an LLC without thereby risking large, immediate tax liability. So, for the existing corporate enterprise to obtain pass-through treatment, it is Subchapter S or nothing.

While LLC and partnership taxation afford the sophisticated investor far more in the way of elections and choices, in one large respect the S corporation is superior. An S corporation can be party to a tax-free reorganization; an LLC cannot.

So if, as I believe, Subchapter S will retain long-term vitality, then improving the system is a good idea. I believe that Senate bill S. 758, in most respects, is in the right direction, in looking to expand Subchapter S eligibility, and to reduce the likelihood of inadvertent termination of S corporation status.

But, inevitably, in these taxing matters, there are problems. The bill is surely a good beginning, but it is not yet a good ending.

The proposal to allow tax-exempt and foreign investors to hold S corporation shares is, I think, a truly bad idea. It is entirely inconsistent with the simplification notion that underpins Subchapter S.

Every study of corporate shareholder integration—and particularly recent American Law Institute and Treasury Department reports—agrees that a sizeable part of the complexity that develops,

both in theoretical models and in the integration regimes already in place in other countries, is attributable to the participation of exempt and foreign shareholders.

So my first and strongest recommendation this afternoon is—do not do this.

The bill's other proposed major innovation, allowing an S corporation to operate through subsidiaries, I see entirely differently, and view with the greatest favor. Most of all, I applaud, as I am sure will multitudes, the proposal to treat a wholly-owned subsidiary of an S corporation as a division of the parent, thereby extending pass-through treatment to the entire incorporated operation. It is a proposal that advances the system in many ways, most notably in promoting efficiency.

If, for business reasons, an enterprise is best conducted in parent-subsidiary form, it is plainly crazy for the tax law to announce, as currently it does, convert to a single corporation divisional structure, or we will double your taxes.

As drafted, this excellent proposal does present some problems, almost certainly unintended, that merit address. For example, treating the wholly-owned subsidiary as a branch of the parent S corporation should extend to a foreign subsidiary, as I believe it does in the bill, but presumably should not extend to a subsidiary that is a so-called ineligible corporation, as perhaps it does in the bill too.

More generally, treatment of the subsidiary as a division should be made explicitly elective. In the bill, it seems to be automatic, which means that if the taxpayer wants to elect out of this treatment, the taxpayer does so by conveying one share of the subsidiary's stock to a third party. That sort of transactional election exemplifies tax inefficiency.

Concerns of this sort—inevitable at the initial stage of tax legislation—can be dealt with and will, without doubt, be appropriately dealt with if the Committee adopts for the benefit of the staff, the Treasury, and all the rest of us this straightforward policy: Issues of legislative detail are to be resolved in a way that both preserves the simplicity and promotes the efficiency of operating through an S corporation.

Mr. Chairman, I will be delighted to answer any questions. I hope you will ask all of us questions about the Treasury's earlier testimony, when I think it foolishly suggested that we ought to limit the size of S corporations.

Senator HATCH. Thank you so much. We will be glad to do that. We appreciate your testimony, and we appreciate your suggestions as well, so keep them coming.

We will now turn to Dr. Hamill, and we look forward to hearing her testimony.

[The prepared statement of Professor Ginsburg appears in the appendix.]

## STATEMENT OF SUSAN PACE HAMILL, ASSISTANT PROFESSOR OF LAW, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, AL

Professor HAMILL. My name is Susan Hamill. I am an assistant professor of law at the University of Alabama. Before joining this

faculty, I spent four years at the Internal Revenue Service as an attorney adviser in the division that has jurisdiction over S corporations, partnerships and limited liability companies. Before that, I practiced four years in New York.

I am here today as sort of the bad guy of the group. The Subcommittee has asked me to address a broad, fundamental question—do we need to reform Subchapter S at all, given the recent growth and acceptance of limited liability companies?

After a great deal of thought my answer is no, if you are future oriented, primarily on resource allocation grounds. I hate to differ with Professor Ginsburg, who taught me once, when I was a student. Forgive me for my disloyalty.

Professor GINSBURG. Yes.

Professor HAMILL. But I will proceed on. Former students are allowed to disagree.

In recent years, the limited liability company has experienced a great amount of growth. In 1988, when the Service recognized that it could be taxed as a partnership, it was an obscure form.

Between 1988 and 1994, almost all 50 States passed limited liability company statutes. Moreover, the Internal Revenue Service recognized in Revenue Procedure 95–10 that the classification rules should be applied to LLC's in a manner similar to limited partnerships which, makes it fairly easy for LLC's to be classified as partnerships without a great deal of pain.

Moreover, the Service has further proposed, in response to the President's directive to get rid of obsolete and burdensome regulations, to just ignore the classification regulations with respect to certain unincorporated entities, and allow taxpayers to elect partnership or association treatment, commonly known as the "check the box approach."

As a professor, and as a scholar, I support Revenue Procedure 95–10—because there is no valid reason to treat LLC's and limited partnerships differently—and I also support the substance of the Service's "check-the-box" proposal because, when you carefully study the classification regulations, they have evolved to be merely formalistic distinctions that do not carry any business reality. The only thing they do is gin up transaction costs for the Government and, of course, they increase fees for lawyers when people want to straddle the line and still comply with the regulations.

And, you might ask, what does all this have to do with the S corporation bill? Because future businesses, I would predict, are going to overwhelmingly choose the limited liability company, rather than an S corporation. I recognize that I am ignoring a very important problem, which is what can corporations do that want to convert to LLC's? Professor Ginsburg is right. Corporations currently using Subchapter S have a big problem because they cannot liquidate and convert to an unincorporated form without paying a toll tax.

The closely-held corporate form on a business level, forgetting taxes for a moment, had to go through a long, painful history to accommodate itself to the little players. Because the LLC statutes are drafted in a manner that better accommodates small business Future small businessess will likely choose LLC's independent of tax considerations.

And so, for tax and business reasons, a least as far as future choices, the LLC will likely be the dominant form. So my question would be, why would we want to spend the time and energy to introduce new legislation and write regulations on it, when we already have the future form before us?

The other reason, that I oppose the bill, is a little more arcane and academic, but more long-term oriented. My second reason for opposing the bill looks at the S corporation bill in the big picture of the taxation of business organizations as a whole.

The current system for taxing business organizations has serious serious flaws. You have two major regimes, the corporate provisions and the partnership provisions. If you incorporate, even with a close corporation, the corporate provisions apply, and you face a potential double tax at the corporate level and at the shareholder level.

The double tax can be avoided by electing Subchapter S. However Subchapter S has great limitations, even under the bill, when compared to partnerships. Close corporations can use self-help techniques by trying to pay all income out in deductible items.

However, if you choose an LLC or partnership, you get the partnership provisions, which are much more flexible than Subchapter S. Those provisions impose one level of tax at the owner level. But, when you look at the business characteristics of a small business, it often looks the same, regardless of which one of these forms you choose. The form of organization for many businesses is a label, and nothing else, yet you have these different tax results. I would view that as the big problem with business taxation.

The S corporation bill really does not do too much to solve the fundamental problem behind business taxation. Although the bill makes S corporations a little more attractive it merely nips at the margins of these inequities.

In closing, I urge the tax policy makers to address the bigger question—that is, equivalent business entities receiving vastly different tax results, based on the form of entity chosen. I would offer any assistance I could provide, and I would be happy to answer any questions.

Thank you.

Senator HATCH. Thank you so much.

We will turn to Mr. Starr as our last witness here.

[The prepared statement of Professor Hamill appears in the appendix.]

## STATEMENT OF SAMUEL P. STARR, MEMBER, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. STARR. Good afternoon, Mr. Chairman, and Senator Pryor.

My name is Sam Starr. I am a member of the tax executive committee of the 320,000-member-strong American Institute of Certified Public Accountants. In my role as a member of the tax executive committee, I serve as the liaison to the AICPA's S corporation committee, and I am also its immediate past chair.

On behalf of Deborah Walker, chair of the AICPA tax executive committee, I thank you for providing the AICPA this opportunity to testify on S. 758.

Enactment of this legislation would considerably modernize Subchapter S of the Internal Revenue Code. This legislation is a high priority for the AICPA, and we have taken a leadership role in the effort to reform Subchapter S. Many of our 320,000 members prepare tax returns for, and provide planning advice to, the 1.9 million S corporations that are out there. As noted earlier, that is 48 percent of corporate tax return filers.

Most of these are small businesses, and they are organized as S corporations. Our members know first hand the restrictions imposed, and the complexities that they encounter under the current S corporation regime.

Our awareness of the real-world situations that small businesses face today convinces us that it is time to amend the Tax Code to better reflect business realities in the 1990's, to simplify tax compliance of S corporations, and to enhance capital availability for America's small businesses.

S. 758 will achieve these important and laudable goals. And the AICPA is proud to voice its strong support.

The S corporation reform legislation enjoyed strong bipartisan support in the last Congress, during which the Senate reform bill, S. 1690 obtained 38 Senators as cosponsors—20 Democrats and 18 Republicans.

At its introduction on May 4 of this year, S. 758 received bipartisan support, and now has 29 cosponsors. Further, the reform effort has attracted broad business interest and support from different sectors of the business community, a fact that is clearly demonstrated by the large number of diverse organizations that have publicly come out in favor of S corporation reform.

Many of the prohibitive restraints currently in Subchapter S date back to its original enactment in 1958. That is 37 years ago. The financial environment in the 1990's is far more complex than 4 decades ago, and the 1950's legislative constraints are handicapping small businesses today. A small business simply does not operate—and, if it seeks to survive, should not operate—the way a small business did 40 years ago. Times and financial transactions were simpler then, but much more complex now.

Subchapter S requires a fresh outlook for the 1990's and beyond. The current rules are antiquated and, in many respects, the S corporation faces obstacles and limitations that are not imposed on other entities.

The S corporation reform package, taken as a whole, would modernize the Code by focusing on four broad goals. They are: (1) expansion of capital formation techniques; (2) preservation of family-owned businesses; (3) reform of S corporation fringe benefit rules; and removal of undesirable tax traps.

Modernization is needed so that these new businesses that choose the form of the S corporation will be as attractive a choice as the regular corporation or the limited liability company.

The time has come to level the playing field and bring S corporations on a par with the LLC and the regular corporation. The S Corporation Reform Act of 1995 contains 25 separate proposals. You are familiar with all these proposals.

The S corporation reform bill differs in three ways from last year's bill. First, the bill would permit the S corporation to hold

wholly-owned S corporation subsidiaries. I agree with Professor Ginsburg that it is a very dramatic and important change, and it would very much be a simplification from a business structuring point of view.

Second, the bill would not put 2 percent S corporation shareholders in the same position as owners of C corporations, with respect to their health insurance costs.

Third, there is a transitional relief rule in the effective date regarding terminations.

The legislation would not alter the essence of Subchapter S taxation. Rather, it merely would remove a significant number of obstacles that entrepreneurs who own S corporations have long identified as major hindrances to their growth.

S. 758 would amend the Tax Code to allow small businesses to keep pace with the realities of modern business, without compromising the framework of our Federal tax system.

As I like to tell my students at Georgetown, this reform bill would remove the straight-jacket restrictions that are imposed on these S corporation entities.

For instance, there is the problem with accessing debt financing from commercial banks. This proposal would make venture capital more accessible. But I do agree with Mr. Kohl that a convertible preferred stock would make that venture capital even more accessible. And the AICPA would be very supportive of that change.

As already noted, there is a new reformed entity, the LLC. And the question before us is whether we need to reform Subchapter S now if the LLC is going to be the entity of the future. We have discussed that matter. Clearly, there is a toll charge for exiting corporate solution.

The LLC is not the answer for existing entities; it may in fact be the answer for new entities, but that is a question yet to be resolved. But, for our existing S corporations, we clearly need to take a look at the S corporation reform package.

I would like to close with the fact that we are very very supportive of this legislation. We thank you, Mr. Chairman and Senator Pryor, for introducing this important legislation, and applaud the Subcommittee for being the first Senate body to provide a public forum on the bill.

We stand available and ready to take any of your questions now, and to assist your staff in making this legislation even better.

Thank you very much.

Senator HATCH. Well, thank you. I think all four of you have done an excellent job.

Senator Pryor, shall we turn to you first?

Senator PRYOR. Thank you, Mr. Chairman. I enjoyed this panel very much. Of course, this issue is of great interest to me, and to Senator Hatch.

I might say to you, Mr. Barney, that in Utah we understand it to be the Hatch-Pryor proposal; in Arkansas, it is the Pryor-Hatch proposal. [Laughter.]

But here in Washington, where it counts, it is the Hatch-Pryor proposal. And Senator Hatch has done a remarkable job in pulling all the interests together in this, and getting ready for today's hearing.

I would just like to say, Mr. Chairman, in due respect of Professor Hamill, I do not approach this as an either/or situation for an LLC versus a Sub S issue. I just do not approach it that way. There might be a place for both, but I think to try to indicate or to imply that what we need to do is do nothing about Sub S is to truly just wipe out any interest whatsoever in some 1.6 million Sub S corporations we already have out there existing under 1958 rules.

I think that we need to look at the possibility of expanding the opportunities for those 1.6 million businesses, and to sort of arrive at a parity, if I could call it that, between the Sub S and the limited liability companies.

Professor HAMILL. Your statement addressed the second part of my remarks. I am not saying that small business reform is inefficient under all circumstances. If you are going to do small business reform, you need to look at the big picture and perhaps allow some businesses who choose to be corporations to have more of the benefits of partnership taxation.

There are some ideas floating around out there of actually allowing S corporations to choose to be taxed as partnerships. And I have not thought that through myself, but I am working on a research project concerning that.

So I think you misunderstood my remarks, in that I am not implying that you should do nothing. What I think you should do is back up and look at the problem in a bigger sense.

I do not think this bill does enough toward addressing the big problem. For example, the provision allowing preferred stock. While that goes a long way toward providing more capital flexibility, preferred stock is still treated as interest on both sides of the fence.

I view the preferred stock provision more as an increase in the straight debt safe harbor than a real chance for S corporations to be able to flexibly allocate the economic profits. In a partnership or LLC, for example, if one person puts up the money and another person puts up the idea, you can give the money person a huge share of the income up front. Then, hopefully, when the idea pans out to be something wonderful, you can flip the profit ratio at another point as many times as you want.

And, economically and under the Tax Code, this arrangement works if you are an LLC or a partnership. With classes of stock, it is hard but not impossible to achieve these results economically, even with a C corporation. However, the preferred stock option you are proposing for S corporations does not allow them the flexibility even enjoyed by C corporations to accomplish these economic goals.

Senator PRYOR. Well, I appreciate that response. I am going to turn in just a minute to your former professor, Professor Ginsburg, and have him comment on a couple of statements you have made.

But let me ask a specific question to Professor Ginsburg. I need a little education here. In general, with an LLC, it is my understanding that the LLC, as partners, can have tax-exempt organizations and non-resident aliens. And, if so, would they not therefore be treated better than a Subchapter S corporation and, if so, why should they be treated better?

Dr. GINSBURG. Well, let me try all of that. The question of who can be an owner of a limited liability company is a State law question, rather than a tax question. The tax law does not care. As far as I know, the LLC laws in 47 States and the District of Columbia do not put limitations on those. At least I have never seen any.

Therefore, you can have a tax-exempt partner in the LLC. You can have a foreigner. You pay a price. The price you pay is clearly affordable for those who want to do it. It is in the complexity of the system. The foreigners are treated as engaged in trade or business in the United States through a permanent establishment, for purposes of our tax treaties, bringing in a whole complex regime to deal with them. The tax-exempts are in the world of unrelated business income tax, more complexity.

So why do we treat them better in a partnership or LLC, and let them do that? We have a long tradition, going back longer than I have been in the tax field, in Subchapter K, the partnership regime, that we will put a high priority on flexibility and let you do a great many things.

In recent years, we have been curtailing that somewhat, almost each time with more and more complicated rules to deal with more complicated schemes. So we say the LLC is a part of the partnership world, and we will trade away simplification. We will have the most amazingly complicated rules. And if everybody wants to live with that regime, that is fine.

I think the people who want to do that mostly are not the small business people. I do not know very many small business people that have foreigners as shareholders in their corporations, or tax-exempt institutions running around as part owners.

In Sub S, we say we will not have any of that. And the prize we give you for leaving those people out of the game is the reward of a much simpler taxing system. There are no complicated rules in Subchapter S about disguised sales or special allocations, or what have you. And the reason the thing works as well as it does is because the people who want to do wonderfully complicated things, represented by wonderfully complicated tax lawyers, are in the partnership world, and not in the S corporation world.

Senator PRYOR. Good. Thank you.

Mr. Chairman, I think that at a point in the record, to make our record for today's hearing, which I hope our colleagues will study as we go forward with this legislation, the staff of the Joint Committee on Taxation has prepared an excellent summary of some of these issues.

On page 17, I would just draw to the attention of my colleagues and the witnesses a composite picture of the small share of corporate assets held by Sub S corporations. The summary points out that, despite the rapid growth in the number of S corporations, they are still basically small businesses. I offer this in response to those who have indicated that they have a great fear that these Sub S corporations would become large businesses overnight, and take advantage of the Tax Code, and that we would be giving a benefit or an unneeded windfall to large corporations and businesses.

I would just ask, Mr. Chairman, that the first paragraph be placed in the record to identify who these Sub S corporations are.

Senator HATCH. Without objection.

Senator PRYOR. I think it is very good.

I think that Mr. Barney is a Sub S corporation, and I was amazed at your growth. I was pleased at your growth. It is always a great American success story to hear about your father starting this particular firm, and seeing it grow as it has in a healthy way. I think this is the purpose of what this is all about, to allow and venture out to encourage, and make that growth occur in even more businesses like yours, family owned corporations.

Finally, Mr. Chairman, I just want to thank our friend, Mr. Starr. He has been on the front line here many times on these issues related to the Sub S issue. And he has been a great source of knowledge to us. We are very indebted to him for that.

And, Mr. Chairman, I am going to yield back my time to you. And I thank you, sir.

Senator HATCH. Well, thank you, Senator Pryor. I particularly appreciated this panel myself.

Let me ask a few questions. Mr. Barney, do you think that your business would have grown more over the last few years if the restrictions on S corporation, which S. 758 would remove, had not been there?

Mr. BARNEY. Yes. Under the S corporations, I understand, we are not allowed to have other companies. We are only allowed to have the existing one. That has kind of held us back. Going into some of the surrounding States, there is a lot of increased mining, and a lot of work out there, along with expanding Utah too.

And we have hated to jeopardize our existing company, the one our father built, the bread and butter of the whole thing. He is 71 years old now, and he is a little hesitant to go out and take on big risk. He wants to stay a little more comfortable, so we have not been able to expand and go out into the other markets without somewhat jeopardizing our existing one, which we do not want to do because they are a customer we have worked for over 50 years. We are very loyal to them, and want to stay that way.

Also, even with some of those, our existing customers do large power plant deals. We haul a lot of coal and things like that. You can need 20 trucks within a year, something like that. We do not have the ability to raise that kind of capital through the banks and stuff like that, to come up with money that fast, and it is at an awful high rate of interest anyway. And this puts us at a disadvantage with some of our larger competitors.

Senator HATCH. Have you ever considered converting your business into a limited liability company?

Mr. BARNEY. No, we have not. We have talked about it, but the tax would be disastrous. We would be basically taking our company and changing the status to an LLC, we would have to transfer all the equipment and everything. It would just be more or less on paper, and then we would have to pay the taxes on all of that.

Senator HATCH. Well, if the LLC, as you put it Professor Hamill, is the wave of the future, or at least as I am paraphrasing the way you put it, why can we not just automatically shift all these S corporations into LLC's?

Professor HAMILL. Mr. Chairman, is that directed to me?

Senator HATCH. Sure. If we cannot do it, maybe we could at least let them elect to do it, as long as it is longer than 10 years.

Professor HAMILL. To answer the first question—why can't all S corporations convert to LLCs—the reason why is because the corporate world and the partnership world, do not mix.

In order for Mr. Barney to change his S corporation to an LLC, he has to liquidate it under the corporate tax provisions, which will cause a tax at the corporate level, and the shareholder level.

If Mr. Barney's business were operated in a general or a limited partnership, he could liquidate the partnership and form an LLC without paying any tax at all, while keeping the historic cost of the assets intact. That is, after the conversion Mr. Barney would not get more depreciation, and Mr. Barney would pay tax on the appreciation of the assets later. But Mr. Barney would be able to shift over tax-free. You can do that in the world of unincorporated forms; you cannot do that from corporate to unincorporated forms.

When people say, gee, I have a new small business, what should I do? Should I form an LLC, a partnership or a corporation? My response is, only form a corporation if you know you never want to change into another form because it is like a one-way street, you cannot get out of the corporate form tax-free.

And, to respond to your second point, maybe as part of another bill, one that addresses the fundamental problem with business taxation, one should consider allowing S corporations to convert to LLCs without paying Uncle Sam. That would involve changing some of the corporate tax provisions. I would urge you to consider that as part of a bigger picture look at this problem.

Senator HATCH. Well, it is a little more complex than that though, is it not, Professor Ginsburg?

Professor GINSBURG. I was sitting here and realizing that my future, to the extent I do any tax practice, is secure. The opportunities are limitless.

Professor Hamill has a good point, of course, about the fact that we have a very discordant business taxing system. But I think it was Voltaire who said that, "The best is the enemy of the good." I believe he said it in French actually. [Laughter.]

Professor HAMILL. Or he said it in Code, Professor Ginsburg, which is probably worse than Greek.

Senator HATCH. I think he said that good is the enemy of the bad.

Professor GINSBURG. The idea of reforming the entire system is very attractive and, no doubt, we will be thinking about that come this fall, looking at some of the other proposals.

But we are not going to run into grand reform so quickly. And I think improving Subchapter S, standing alone, is worthwhile.

Senator HATCH. Well, let me get back to Mr. Barney, because you are living with these problems on a day-by-day basis. And you are indicating that your vistas are limited unless we get this bill. And, even then, they would be limited in comparison to a limited liability company.

What is the current cost of your capital, and how would that cost of capital change if we passed this bill, S. 758?

Mr. BARNEY. Could you say that again please?

Senator HATCH. What is your current cost of capital, and how would your cost of capital change if we enact S. 758?

Mr. BARNEY. Our current cost of capital right now is about 9½ percent. And that is if we secure it with 100 percent collateral, with all of our equipment.

Senator HATCH. And that is with you signing personally on it?

Mr. BARNEY. And we sign personally too.

The bank came down this last time, when we borrowed money in 1994 and said, we will lend you money at 4 percent. You give me a million dollars, and I will lend you back a million dollars.

Well, I was virtually borrowing my own money back, and they were going to charge me 4 percent to do it. But we do not have the alternatives to get the 6 percent that a lot of them are getting now because our only available income, or borrowing anyway, is the banks and our own money. If this changed, we know people who would put money in. We have family members that would invest more into it. But, under the present law, we cannot do that.

Senator HATCH. I see. Have you found it difficult over the years to operate under Subchapter S, in connection with complying with all the special rules that Subchapter S requires?

Mr. BARNEY. No. We have operated under Subchapter S. We have done well under Subchapter S.

Senator HATCH. But do you think it would make it easier for you to do it even better?

Mr. BARNEY. Yes, I do. Because that would allow us to be able to expand, operate other companies, and get better financing.

Senator HATCH. How many employees do you currently have?

Mr. BARNEY. One hundred twenty-three.

Senator HATCH. Would you set up an ESOP if S. 758 was passed?

Mr. BARNEY. We would look at it very seriously. We have not had that opportunity, but we would like to have that opportunity, as other companies do.

Senator HATCH. How many of your employees would participate, if you have any idea?

Mr. BARNEY. At this point, I do not. I know we have a few long-term employees who have been with us 15 or 20 years, and some key personnel who would definitely be interested in it, but it would take some study to do.

Senator HATCH. I take it that you have some children back in Utah who might participate in the business, right?

Mr. BARNEY. Right.

Senator HATCH. All right. If so, are you planning to pass the business on to them when you get your father's age?

Mr. BARNEY. Hopefully. He is trying to pass it to us right now. We have a lot of restrictions there, and our children are basically still young. There are some in college now. But I believe that is everybody's dream, to be able to pass it on to their children.

Senator HATCH. But, if you tried to do that under current law, you would have the same problems you are having with your father passing it on to you, right?

Mr. BARNEY. Right.

Senator HATCH. And that would change if we pass this bill?

Mr. BARNEY. Yes, it would.

Senator HATCH. All right.

Well, it seems like it makes a lot of sense. Let me go to Professor Ginsburg for a few minutes.

You mentioned in your testimony that adding tax-exempt organizations and non-resident aliens to the list of allowable S corporation shareholders would add complexity to the Code.

Professor GINSBURG. Well, to the extent that you say there will be additional potential investors, there is always an advantage to that. The question is, what are you trading for it? I believe this is the question Senator Pryor asked me, in a different context.

Here I think that the price, in terms of complicating a system that essentially is not complicated, is, first, much too high and, second, unnecessary to pay.

That is, if an enterprise really, truly needed to have foreign shareholders, and it is an S corporation, you can do the equivalent of admitting a foreign shareholder by having the S corporation take its business and transfer downstream into a joint venture or partnership, in which the non-resident alien becomes a partner.

Let us say the deal is that the alien or the alien group is to be 50 percent owners. You can do it that way. The S corporation remains an S corporation, and 50 percent of everything flows up to it for tax purposes, assuming straight-up 50:50 allocation. The foreigners are in there under the U.S. tax rules, which are well developed for foreign partners. So this is not a show-stopper problem. You can attract the foreign investor. The narrow question is whether you want to allow aliens to become shareholders in the S corporation, and pay the price of taking that very complex international taxing regime and layering it on top of Subchapter S.

If you do this, I believe that within a certain period of time, given the history of the tax law maybe within 5 years, you will have a total shambles.

Mr. STARR. Mr. Chairman, can I speak to that question?

Senator HATCH. Sure.

Mr. STARR. The AICPA would call this concern elective complexity. The AICPA is very much in favor of a simplified Code. The changes we are suggesting here, with respect to non-resident aliens, and exempt organizations as shareholders, is elective complexity.

Mr. Barney, if you want a non-resident alien, your world would get more complex under this particular legislation. If you do not want a non-resident alien as a shareholder, you do not have to have one, and you can have a more simplified arrangement.

I would also suggest that we are accessing non-resident alien capital today, just as Professor Ginsburg suggests. We are using LLC's as lower-tiered entities. And, you know what? That is more complex than just having the non-resident alien investing as a stockholder in an S corporation and subjecting that S corporation shareholder to withholding, as this bill would propose to do.

So, the way I look at it, it is sort of elective complexity. Regarding exempt organization shareholders, this legislation would allow pension funds, for the first time, to invest in S corporations and that source of capital. It would allow S corporation shareholders to set up private foundations for charitable purposes. It would also allow charitable organizations to receive S corporation stock as part of an estate plan. Presently, they cannot do that.

Many S corporation business owners are business-rich, in the sense that they have a lot of assets in their business, in their stock, but they do not have a lot of cash per se. So they like to take their stock and give it over to charity. You cannot do that with an S corporation today.

So, if you want to do those transactions, you are electing complexity, but I think that should be an available option to S corporations.

Professor GINSBURG. Well, I guess, two points. One of the nice things about elections, whenever you give them, is that they do complicate things because then you have to think about everything two ways, and usually get it wrong one-third of the time.

Second. in fairness, Mr. Starr left out one of the reasons why one would want to allow an S corporation to have a charity or a foundation as a shareholder. As he knows and I know, the best reason is that I can then take some shares of my S corporation, give them to the private foundation or the public charity, have the shares redeemed tomorrow morning, claim a large tax deduction for having done this, and not jeopardize my S election.

In other words, there is nothing to be said for that scheme other than it will reduce my taxes significantly.

Mr. STARR. Well, Marty, I appreciate the comment there. Indeed, there is a transaction where you do give stock over to a charity. And, indeed, you can redeem that stock out. The case law permits it. It is not done overnight; it is not done in 24 hours. It is done over a period of time.

Senator HATCH. And I understand that. Maybe I am wrong about this, but is it not true that an LLC dissolves upon the death, bankruptcy or resignation of any member?

Professor HAMILL. That was true before Rev. Proc. 95–10.

Senator HATCH. Yes. And let me just state the rest of this though. Upon dissolution, the LLC must be wound up and terminated unless all of the members consent within 90 days to continue the LLC. Furthermore, the unanimous consent of all LLC members is required to transfer an LLC interest to a non-member. Are all those still law today?

Professor HAMILL. No.

Senator HATCH. All right.

Professor HAMILL. Under Rev. Proc. 95–10, LLCs can lack continuity of life with the members concentrating the dissolution possibility upon one change event of the managers. Normally, the popular choice is bankruptcy. And a majority interest rather than all the members can agree to continue the business and avoid a dissolution. The majority interest is calculated on an economic basis, as opposed to a head count.

And, for transfers, you only need majority consent for a complete transfer. Either a majority of the members or the managers can provide the consort. And you can calculate majority under a variety of ways—head count, economic, for example. Moreover LLCs only need to require slightly more than 20 percent of the interest to obtain consent.

So the LLC enjoys almost the same business stability as the limited partnership.

Moreover, if the Service decides to adopt check-the-box, by just ignoring the classification regulations—because they really do not draw distinctions based on real meaning anyway—the LLC, the limited partnership and some other unincorporated forms, will essentially receive automatic partnership treatment.

I have done some research and written an article supporting the policy behind Rev. Proc. 95–10 and the check-the-box proposal, which I have available for your use if you would like to see it.

Senator HATCH. We would like to see it.

Mr. Starr, I take it then that you are making the case that, if we pass this bill, it will make capital formation much easier for S corporations. I think you would all agree with that. Right? Am I wrong?

Professor GINSBURG. Which part of the bill, Senator? Are you referring to allowing the foreigners and the tax-exempts to become shareholders?

Senator HATCH. Sure. But also, would not some of the other provisions assist in capital formation?

Professor GINSBURG. I think some of the other provisions are great, and would do excellent things.

Facially, I think it would——

Senator HATCH. It would make it more attractive.

Professor GINSBURG. I think Mr. Barney said it so well, about the ability to use subsidiaries, how important that is to being able to run the enterprise in the most efficient way.

As far as the foreigners and the tax-exempts, my view is that facially it will mean that there are more folk who can get involved. But, realistically, if it will matter very much is really difficult to predict.

Senator HATCH. All right.

Mr. Starr, will this bill make compliance with Subchapter S more or less complicated?

Mr. STARR. I think, if you use some of the provisions in this bill, like providing for a non-resident alien shareholder, because this bill provides for withholding on that non-resident alien shareholder's income allocated to him or her, yes, this bill would provide more complexity for the S corporation owner.

But, referring back to my other comment, I feel that that is elective complexity. We are not requiring that everybody have a non-resident alien shareholder. We are not requiring having tax-exempt organization shareholders; we are making that option available to them. So there are certain instances here, under this particular package, that could cause more complexity.

On the other hand, there are other provisions in this bill that provide for a simpler Subchapter S. One of them, in my opinion, again goes back to the wholly-owned S corporation subsidiary. Today, we have to have up to 79 percent owned C corporation subsidiaries, and we have two corporate tax returns.

When you go to a wholly-owned S corporation subsidiary, treated as a division of the parent entity, you file one tax return. And that would simplify tax return preparation.

So there is some complexity, and there is also simplicity in this bill.

Senator HATCH. Well, do you agree with Professor Hamill, that most new enterprises that traditionally would have elected S corporation status, will in the future become LLC's

Mr. STARR. Indeed, many of my clients are looking at the LLC, now that it is truly available, as an option for their new operations.

I would have to tell you that it is not clearly the absolute choice that they chose the LLC. There are still reasons to be an S corporation. Mr. Barney may have considered moving to LLC status. But one question I would probably ask him is why? Because the Subchapter S entity provides everything that Mr. Barney needs to do.

Many closely-held business owners are not interested in specially allocating income. It is something that they really do not need to do, and have never really thought about doing. The S corporation form is rather simple in that regard. Therefore, I think it is very attractive, and would be attractive even to a newly-formed corporation.

Senator HATCH. Well, we will be interested in any suggestions you might have that would make this less complex. But it still takes us forward with regard to making some of the changes that, I think, most of you agree with.

Let me just say, Mr. Starr, you are understood to be one of the most knowledgeable tax experts in the country on the issue of S corporations. Will S. 758 really make a difference to the average S corporation, or will it only make a difference to a few well-heeled businesses that want to go beyond the traditional role of S corporations?

Mr. STARR. I think that this particular legislation that you have introduced will make substantial differences to many smaller S corporations. I think it will also benefit a few very, very large companies. I cannot promise you or anybody that there are not going to be some large entities out there that would use this legislation to elect S status. May I suggest to you that many of those companies already are S corporations.

But, for the most part, this legislation was designed over a 3-year period of time, by members of the American Bar Association, the AICPA and the Chamber of Commerce to speak to our clients' day-to-day transactions, the things we see every day. Those clients are smaller entities, and we are trying to help them with their transactions.

Senator HATCH. Well, I do not mind larger corporations benefiting also, because maybe they can hire more people, do a better job. They can help the economy over the long haul anyway. But you are saying that smaller corporations will benefit as well, S corporations?

Mr. STARR. Yes. For the most part, there is no question that the entities that will most likely benefit from this legislation are the smaller entities out there.

Senator HATCH. Like Mr. Barney's?

Mr. STARR. Yes, sir.

Senator HATCH. Well, this has been very helpful to us. Let us leave the record open. We would like to have further suggestions from all of you as to how we can perfect this bill.

Senator PRYOR. Mr. Chairman?

Senator HATCH. Yes.

Senator PRYOR. I do not want to interrupt you, but I do not know if, earlier in your opening statement, you listed some 16 organizations that are supportive of our legislation.

Senator HATCH. I do not think I did.

Senator PRYOR. If you did not, I would like to ask you, sir, to consent to place that in the record. It is a wide array, from the U.S. Chamber of Commerce to Associated Equipment Distributors, the National Association of Life Underwriters and NFIB. It is a very impressive set of endorsers, I guess you would say, for this legislation.

Senator HATCH. So there, those of you who disagree with our bill. [Laughter.]

We realize that these tax changes are always difficult. We think the bill is a good one, but we also are interested in improving it wherever we can.

We think this panel has been particularly good. We admire each and every one of you, and we are grateful for your time and attention. We hope you will not end it here, but will make suggestions to us, between now and the time we get to the floor on this, so that we can make it as perfect as we can.

Our goal here is to do what is right. It does have a our heads spinning when we listen to you experts. Maybe it would be better to go to some sort of a single simplified system of the Code, if that is possible.

Be that as it may, we want to thank you all for being here. With that, we will recess this Committee until further notice.

[Whereupon, at 4:10 p.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED

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### PREPARED STATEMENT OF BRAD BARNEY

Good morning. My name is Brad Barney, and I am the President of Barney Trucking, a small business located in Salina, Utah. I am also a member of the S Corporation Reform Project, and I am here in Washington, D.C.—for the first time ever—to speak for my business and for S-CORP on the need for S Corporation Reform legislation in this Congress.

I am grateful for the Chairman's invitation to testify this morning before the Subcommittee on an issue that I believe is critical to my business and thousands of others like mine in the State of Utah and, as I understand it, more than 1.6 million S corporations nationwide. Our businesses desperately need reforms to the outdated operating rules which were originally crafted nearly 40 years ago, but which are no longer applicable today.

In Utah, so many of our businesses are small, family-owned or otherwise closely controlled—typical characteristics of S corporations—that I am joined today by my colleagues from several other Utah companies to bring to this Congress an important message from Utah's business owners. Those which have joined me today include: Robinson Transport, also from Salina; Utelite from Coalville, and Lynn M. Carlson & Associates, from Salt Lake City.

As an S corporation owner, I was specifically asked to address the current prospects for American business owners like myself to access capital, and to suggest some of the ways in which access can be improved. First, though, I would like to thank the Chairman, his esteemed colleague, Senator David Pryor from Arkansas, and this Subcommittee for their efforts to create an environment in which American business owners like me have the opportunity to build strong and healthy businesses—companies that can provide for their owners and their employees for generations. The S Corporation Reform Act of 1995, which Senators Hatch and Pryor have recently introduced, would vastly improve the ability of business owners to operate, access capital, expand and continue to contribute to local, state and national economies. It is a major step forward for business owners. Given the size of S corporations' contribution to the national economy as a whole—with more than ten percent of the U.S. tax base attributable to S corporations—I believe that it is also an important step forward for America.

#### BARNEY TRUCKING, INC.

By way of background, Barney Trucking is a major hauler of bulk commodities, including coal, ammonium nitrate, cement, lime and other materials. With only six shareholders, our company has grown rapidly, from a time more than 40 years ago when my Dad owned one truck and waited at the coal mine hoping for a load of coal to deliver, to our current fleet today of 70 trucks. This year, Barney will earn approximately $2.4 million on sales of about $18 million. The company is organized as an S corporation because we have a very small group of individuals who act as the company's principal owners and managers. Our pass-through status therefore makes sense, because the ups and downs of the business should relate directly to this small group.

There are three sources for our company's funding: The owners, the revenue generated by the company and some bank debt. The company's initial capitalization was made up of my father's savings and all that he could borrow, secured by just about everything he owned. Today, we are in far better shape. Each year for the last five, Barney has achieved average annual sales growth of about 11 percent. Today, we have 123 employees at facilities in two states, Utah and Nevada.

In the last year, we have expanded our trucking operation significantly into Nevada. Right now we have six truck and trailer sets stationed in Nevada and employ 24 full-time drivers. There are many opportunities at these facilities for additional expansion, but our rate of growth is limited by the capital we can generate internally.

So you may wonder: If Barney has done so well, why are we concerned about capital access and formation? The answer, in short, is that our company's future and that of our next generation of owners depends upon it. For Barney Trucking, there are at least three major problems that affect us simply because we are an S corporation:

- One, the rules governing S corporations hinder our growth opportunities, and thus directly limit the long-term security of our employees (not to mention the millions of other Americans employed by S corporations around the country).
- Two, the rules make it particularly difficult for S corporations like ours to obtain many types of mainstream corporate financing on reasonable terms.
- And three, inadequate capital access for us and for other S corporations hurts our efforts to maintain and expand operations. Despite our company's strong performance, we could easily expand further if we didn't have to worry about the unnecessary restrictions imposed on us. And while we have been relatively fortunate, many businesses hit hard by slow economic times are in serious, immediate need of the type of help that simply is not available, due to the structure of the rules under which we operate.

While these limitations can be terribly unfair and anticompetitive, I believe that they can be largely overcome by passing the S Corporation Reform Act of 1995.

RESTRICTED CAPITAL ACCESS

As my accountant has long advised me, our company is limited by both law and practice from access to many types of financing that are both standard and important for every other type of company in America—that is, except S corporations.

For one thing, the law prohibits S corporations from issuing more than one class of stock. Effectively, S corporations have only two options for raising initial capital and later-stage money: Either we owners must invest and thus risk our own money, or we are forced to rely on bank debt, which is often limited for a business our size, and which generally requires the personal guarantee of the owners anyway. S corporations are specifically prohibited from having many other forms of capital such as *preferred stock* and convertible debt. But these out-of-reach form of capital are, for all other types of businesses but S corporations, more plentiful than bank debt and more "flexible" than common equity.

If S corporations were permitted enhanced access to these types of debt and equity, I believe we would be able to grow better and faster and—more importantly—with *lower costs of capital.* Even now, during times of historically low interest rates, we pay as much as 9.5 percent to borrow funds. That rate is for a loan that is 100 percent secured by equipment and the personal guarantees of the owners. Considering that our company is a very desirable customer of a number of state and regional banks, it is hard for me even to imagine the capital cost burden on some other business owners I know whose companies may have been less fortunate and are less credit-worthy than ours.

Venture capital is another type of funding that tends to be off-limits to S corporations, again because of the constraints on what types of securities we may issue. While many people associate venture capital with high-technology and start-up companies, the truth is that these funds are frequently utilized for expansion, growth and new projects among longstanding businesses in a wide variety of industries. For our company as well as many others, venture capital is highly desirable, because it comes with fewer strings attached than bank debt, and poses less threat of infringing upon the decision-making authority that belongs to the standard equity shareholders. (This is particularly a concern for family-owned businesses such as ours that want to keep ownership and decision-making within the family, and to pass it along to our future generations.) But S corporations generally cannot get this type of venture capital, because venture capitalists require flexible funding mechanisms such as preferred stock and convertible debt that specifically allow them to limit their risk, yet and still enable them to take part in a portfolio company's upside gains at the appropriate time.

When credit markets are stable, the use of alternative, lower-cost capital sources like preferred stock and convertible debt can be the key to remaining competitive in business. The S Corporation Reform Act specifically addresses our capital restrictions by permitting S corporations to have preferred stock and convertible debt, among other things. Bringing in additional funds and lowering our current cost of

capital would make a real difference to Barney's bottom line. I need hardly tell the Chairman that this, in turn, makes a difference in how we price our services, compete against other businesses, expand our business and invest our limited resources in people and equipment.

Not only would Barney benefit from better and cheaper capital access permitted by the legislation; I am certain our employees would also benefit from the capital-related provisions of the bill. In particular, the Barney employees who are not also shareholders of the company should be able to share in the company's successes more directly. Today, they cannot. S corporations are forbidden from having employee stock ownership plans (ESOPs) because no such "multiple beneficiary trusts" can be shareholders. The owners of Barney, however, would like to be able to ensure that those who work with us are as committed to our business' success, as we have been for more than four decades.

An ESOP would be an ideal way to keep that commitment within our company, to give our workers the opportunity to reap the benefits of their work, and to provide yet another source of capital to help our business sustain the track record we have worked so hard to establish. Without the ability to participate directly in S corporations, the employees of our company are deprived of tremendous opportunities to share in our success and, in doing so, to help provide for their own futures. We and other S corporations, meanwhile, are also being denied, since establishing an ESOP is, more and more, becoming an important new source of reliable capital for small and medium American businesses like ours.

The S Corporation Reform Act recognizes this problem, and responds with a simple and effective solution: It permits multiple beneficiary trusts, which in turn permits S corporations to have ESOPs. From all the positive research that has been done on the gains associated with employee participation in a company, it is clear that great benefits lie in store for S corporation workers, managers and shareholders alike once ESOPs are permitted to be organized within our companies.

## UNIQUE TAX BURDENS ON S CORPORATIONS

Improved capital access for S corporations is an even greater problem when you recall that recent changes in tax rates specifically penalize S corporations like mine, which must reinvest their earnings back into their businesses to sustain growth. Let me explain: S corporation shareholders pay taxes on the profits of their businesses, regardless of whether the company distributes or retains its earnings. Like all employees, we shareholders pay taxes on our take home wages and distributions. The difference is that, since S corporations are "pass-through" entities, shareholders also pay taxes on their share of the company's profits regardless of whether they distribute the profits or whether the company reinvests them.

As you are aware, top federal tax rates increased from 31 percent to 39.6 percent as a result of the 1993 tax bill. Due in significant part to the massive tax increase we sustained, last year, for the first time in more than a decade, our company was forced to incur long-term bank debt. We needed these funds to pay for the additional equipment required for the normal expansion of our operation, as well as for keeping our fleet age current enough to maintain our present level of service.

What does this mean for our company in practical terms? First, it means that there is a built-in disincentive for us to make additional investments into the company—particularly those that are at all discretionary, even though they might greatly benefit the company in the short and long term. Second, it means that the additional funds we pay in taxes are simply not available when we must reinvest in the company, as occurred for us in 1994. Thus, legislation to help free up other sources of capital is all the more important to us in the aftermath of the tax increase.

## CONCLUSION

The legislation introduced by Senators Hatch and Pryor, which is already cosponsored by a solidly bipartisan group of 25 Senators (including Seven Finance Committees Members), would positively address all of the issues I have raised today. It would open up important, alternative sources of private capital. It would ensure that, in the face of increased demands on S corporations' existing capital base, both external and internal funds are available to enable continued growth. And it would also allow S corporations to create ESOPs, providing yet another capital source for businesses while creating major opportunities for employees to benefit from their hard work. I speak for my own business when I tell you that I can guarantee these steps would make a real, competitive difference to our bottom line. But I can also tell you that thousands of other S corporations in Utah, not to mention hundreds of thousands more nationally, are likely to tell you the same thing about what will

happen to their companies when you enact the type of long-overdue reforms included in the Hatch-Pryor legislation. Already, in fact, the S Corporation Reform Project—the only association devoted exclusively to the legislative interests of S corporations—is working with more than 40,000 companies which consider this legislation among the top priorities for this Congress.

I'd like to add that I recognize that this Congress considers itself to be "pro-business," and I am grateful for that support. But the Hatch-Pryor bill is not simply pro-business. It is also pro-labor. By simplifying troublesome estate-planning complexities, it is also clearly pro-family. Perhaps most important, it is pro-community—and by this I mean every community across America, since this is where S corporations can be found.

I thank the Chairman for his work to support Utah's and the nation's business owners by working hard for S corporation reform. I urge this Subcommittee to enthusiastically support the Hatch-Pryor S Corporation Reform Act, and to continue its work to ensure competitive capital access for American S corporations. Thank you for this opportunity to testify. I would be pleased to answer any questions you may have.

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## PREPARED STATEMENT OF MORTIMER CAPLIN

Mr. Chairman and distinguished members of the Committee:

My name is Mortimer Caplin, a member of the Washington law firm of Caplin & Drysdale. I served as U.S. Commissioner of Internal Revenue from 1961 through 1964, during the Kennedy and Johnson years, and have specialized in tax law for over 40 years representing a wide variety of business and individual taxpayers.

I am pleased to appear before this Committee today to present my views on the proposed loosening of the standard for allowing "home office" deductions under Code section 280A.

The deductibility of home office expenses has had a turbulent and unsettled history, primarily due to the mixed character of this expenditure—part personal and part business. Involved here in testing for tax deductibility is differentiating between two competing Internal Revenue Code provisions:

1. One (§ 262) is the general rule disallowing deductions for "personal, living, or family expenses." And usually within this broad category are items such as food, clothing, shelter, travel and entertainment—which for the average citizen is his or her nondeductible personal responsibility.

2. The other (§ 162), in contrast, is the equally fundamental rule that allows deductions for "all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."

Between these two opposite poles, how then do we reconcile an expenditure possessing elements of each?

Assertions of this type of deduction are typically made in settings where a given degree of personal use is being balanced against some measure of valid business use.

Yet, how do we curb blatant tax avoidance when a claimed deduction is essentially personal but can be easily disguised with a purported business mantle? Or when, at very little marginal cost, a small degree of business use is being combined with clearly dominant personal use?

Improper tax classification not only results in significant direct losses of revenue, but perhaps more important—particularly when generally known and broadly used—undermines taxpayer confidence in the fairness of the tax system, stokes resentment and discourages accurate self-reporting.

It is these overlapping characteristics, personal and business, which led to the post-World War II infamous era of "expense account living"—generally referred to as "T&E," or travel and entertainment expenditures. Widely publicized reports of lavish and excessive use of T&E, not only brought heated public criticism, but finally led Congress in 1962 to restrain these practices by adopting a series of disallowance provisions in Code section 274.

Comparable to T&E tax abuses was the well known use of the so-called "home office" ploy—claiming tax deductions for a personal expenditure thinly layered with a veneer of business coating.

With a desk, cabinet and a lamp, just about every Tom, Dick or Harriet was at the quick to claim a tax deduction. And so they did, with IRS agents being assigned the difficult and intrusive task of sifting through mounds of facts, attempting to separate the wheat from the chaff.

It was not until 1976 that Congress put a much-needed halt to these excesses by enacting Code section 280A, which imposed tight limitations on claims for home of-

fice deductions. This corrective legislation eliminated a nagging measure of tax avoidance. And today, if any loosening of the rules is to take place, it should be done only after full understanding of other resulting tax implications. As Supreme Court Justice Robert Jackson once said, taxation is "a field beset with invisible boomerangs."

One obvious consequence of expanding the definition of a home office is its direct impact on run-of-the-mill commuting expenses. For most taxpayers, the cost of travelling from home to work is a personal, nondeductible expense. In contrast, travel between two places of business or employment fall into the allowable deduction category.

What then if your home is allowed to be designated as your "principal place of business" and you still commute daily to your regular downtown business office? What is the revenue cost of this aspect of definitional expansion? How much of an incentive will it be for taxpayers at large to strive for this beneficial home office categorization?

We all know that marked changes are occurring in the American workplace. Broad computer sophistication coupled with a fast-moving information revolution may well lead to reductions of traditional office spaces, the decentralization of office assignments and the extensive use of homesites as legitimate places for doing business.

But as Congress seeks coordination of our tax law with these new dynamics—and as it simultaneously strives to attain a balanced budget—it should move cautiously to avoid opening the door to the potential for artificial arrangements and excessive new deductions, at the risk of significant revenue losses.

With this in mind, I first suggest seeking Internal Revenue's advice on practical problems encountered in the past as well as its views on the administrability of the proposed legislative terminology.

If it is decided to move forward at this time, I strongly prefer the language of S. 327, sponsored by Senator Hatch and others, in place of H.R. 1215. Focused sharply on reversing the results of *Commissioner* v. *Soliman,* 113 S.Ct 701 (1993), S. 327 is more narrowly drawn and leaves less wiggle room for possible manipulation and misuse: It requires that (1) the office must be "the location where the taxpayer's *essential* administrative or management activities are conducted on a *regular and systematic (and not incidental) basis* by the taxpayer," and (2) the office must be "*necessary* because the taxpayer has *no other location for the performance* of the essential administrative or management activities of the business." In comparison, H.R. 1215 employs looser language, allowing space for strained interpretations, excessive controversy and unintended deductions.

Finally, if adopted, S. 327 should be made effective for taxable years beginning only after December 31, 1995. No persuasive case is made for retroactive treatment.

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## PREPARED STATEMENT OF WENDY C. GERZOG *

The proposed amendment to the home office deduction section will cost the taxpayers a lot of money without offering a sound policy justification. It will primarily benefit professionals who are generally in the higher income tax brackets, add to the deficit, and invite fraud and abuse. The deduction is not likely to affect a taxpayer's behavior since the availability of a home office deduction will rarely affect the type of home purchased. On the other hand, to make matters worse, it will allow taxpayers to convert personal nondeductible commuting expenses into deductible business transportation expenses. Finally, even where there is some business use of the home, such use is minimal compared to the loss in tax revenue which results from the taxpayers' being able to take a full deduction for the cost of part of the their home and automobile.

First, even where there is some business use of the home, there is no good policy reason to allow a full deduction for the cost of a portion of one's house and the cost of one's automobile—especially not now at a time we have a huge deficit. Business people who spend a substantial amount of time in their home taking orders and doing billing are already able to deduct their home offices under the current Supreme Court test in Soliman. Since this is an "all or nothing" deduction, under the proposed legislation, a taxpayer who uses his home for business use for only a rel-

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* Some of the ideas expressed in this testimony are developed in greater detail in my article, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuses and Restore Some Progressivity into the Code,* 41 Cath. U. L. Rev. 581 (1992). Copies of this article can be obtained by contacting Professor Gerzog at (410) 837-4522 or by e-mail (wgerzog@ubmail.ubalt.edu).

atively few hours a week will be entitled to a "full" deduction to the same extent as taxpayers who truly have home-based businesses.

Indeed, there is little guidance about how minimally one can use a home office and still get a full deduction. There is no minimal use requirement in the language of the bill except that the taxpayer perform "substantial administrative or management activities" there. Suppose, however, that a taxpayer's business has a small administrative component. If the taxpayer uses her home office for only a couple of hours a week to complete that administrative component, she may, nevertheless, be entitled to take a full deduction for the cost of a part of her home and for her commute to work.

Second, the bill allows taxpayers who would in any event own a den to make that den deductible. Basically, it is hard to believe that these taxpayers would not have a study in their homes regardless of its deductibility. Moreover, the bill will primarily benefit the wealthy as the more lavish the home, the larger the home office deduction. So the cost of converting personal expenses into deductible business expenses will increase the deficit and, yet, the deduction will not generally alter a taxpayer's decision to purchase a home with or without a study. It is also hard to believe that there are many taxpayers who, alternatively, would rent office space to do what typically is a limited task for a limited time each week. How many taxpayers would actually rent additional office space to do billing for about 10 hours a week? It would not be a very sound business decision and it is unlikely that many taxpayers would do it. Further, the fact that a taxpayer does make some small business use of his or her home should not justify granting him or her a full deduction for the cost of a room in that home.

Third, the provision allows taxpayers to convert nondeductible commuting expenses into deductible business transportation expenses. One can envision the following scenerio: the taxpayer gets up, has breakfast, does a little billing, goes to work, comes home, does a little more billing and then eats dinner and goes to sleep. He will have sweet dreams because, unlike most of the workers in this country, he will be able to deduct the cost of commuting to work because he is traveling from one office (his "home office") to his principal place of business.

This conversion of nondeductible commuting expenses into deductible business transportation expenses will probably create a larger revenue loss than the actual home office deduction itself. Again, the larger the car, or even private plane, the taxpayer owns, the greater the deduction. Moreover, it is unclear, but I assume, that the figures of the estimated revenue that will be lost under this amended provision do not include the increased revenue loss that will accompany it under the heading of business transportation expenses. Certainly, this Committee needs to evaluate this additional cost of the proposed legislation.

Fourth, with all of the exceptions contained in the House Report and in the Joint Committee print Descriptions, it is difficult to tell what will qualify or disqualify a taxpayer for the deduction.[1] The ambiguities that will result from incorporating still another test for the home office deduction section will create new complexities in the Tax Code which will be subject to varying interpretations by the courts. Rather than simplifying the home office deduction section, this provision will confuse most taxpayers and make compliance difficult for even the best intentioned.

By contrast, the taxpayer can do substantial non-managerial work at another site. Moreover, according to the House Report, the deduction is available even if the taxpayer has other office space available to do management or administrative activities. (H.R. No. 104-3, 104th Cong., 1st Sess.). According to a Joint Committee print Description issued on February 7, 1995, the use may not be "incidental" and must be "conducted on a regular and systematic basis." But, if very few hours are needed to satisfy the taxpayer's billing requirements, as long as the taxpayer spends such minimal time each week on these activities, while it is incidental in terms of time, is it incidental in terms of the taxpayer's being paid for his goods or services?

Fifth, this new provision invites fraud and abuse. It encourages taxpayers to exaggerate the hours they work at home each day, to pretend that they do, for example, billing both before and after coming home from their main office (to convert these nondeductible commuting expenses into deductible business transportation expenses), and to lie that despite their using their den only a few hours a week for billing, they exclusively use that den solely for such purposes (and never to balance their own checkbooks or as a guest room or a quiet place to read).

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[1] According to a Joint Committee print Description of the provision, others can do billing for the taxpayer at alternative sites; even the taxpayer may conduct "some" of these activities at another permanent or temporary location. (JCX-9-95, March 9, 1995). Thus, the deduction is available to a taxpayer who has secretaries doing billing at his or her principal office as long as the taxpayer does substantial management or administrative activities at home.

One can imagine the impossibility of verifying such minimal use of a home office. Given privacy concerns and the large numbers of taxpayers who will claim entitlement to this deduction, it would be difficult to administer and enforce this provision.

Essentially. the proposed home office deduction is likely to generate a large revenue loss. Yet, it is extremely questionable whether the provision is worth it. Few, if any, taxpayers will change their house choices because of this provision; much additional revenue will be lost by taxpayers converting large nondeductible commuting expenses into deductible business transportation expenses; it will add complexity to the Tax Code; it will encourage taxpayer cheating; and it will be very difficult to administer.

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PREPARED STATEMENT OF MARTIN D. GINSBURG

Mr. Chairman and Members of the Subcommittee:

My name is Martin D. Ginsburg. I am a Professor of Law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. Over the past 25 years it has been my privilege to testify before this Committee on a number of occasions, at times at your request, at times on behalf of a bar association group, often simply out of an interest in the subject under review, but never on behalf of a client. At your invitation I appear today as an academic witness, a disinterested witness I like to believe, but certainly not an uninterested one.

I am very pleased to testify this morning on S. 758, the proposed S Corporation Reform Act of 1995. The Bill extends S corporation availability to more corporations and corporate groups, more shareholders both in number and nature, and more capital instruments, and proffers various other legislative changes of a liberalizing sort. Much of this is welcome, indeed overdue, but the proposal to allow as S corporation shareholders tax-exempt organizations and nonresident aliens is I think unwise. Inevitably, it must add significant complexity to a tax regime a principal justification for which is its relative simplicity in operation. Surely in 1995 the preferred direction of tax legislative change is not toward further complicating the Byzantine. Champions of tax-exempt and foreign S corporation shareholders must shoulder a heavy burden of persuasion in demonstrating the Republic's great need for this innovation. Nothing has yet appeared to suggest this burden can be carried. My first and strongest recommendation to you this morning is, don't do this.

The Bill's remaining eligible shareholder extensions, on the other hand, are salutary in concept although perhaps not fully thought through in detail. I mean to praise with faint but audible damn. The Bill allows 50 shareholders, up from 35, and treats as one shareholder the members of one, but only one, family (and spouses and former spouses) unto the 6th generation. Excellent notions; I would find two families even more so. The Bill would add to the catalogue of trusts eligible to own S corporation stock an "electing small business trust," and while taxing the trust itself on S income the Bill treats each potential beneficiary as a shareholder in determining S corporation eligibility. A detail not addressed: If potential current beneficiaries as well as other shareholders are members of one family, does the advantageous "one family is one shareholder" rule trump? Surely it should, but as drafted S. 758 furnishes inadequate guidance.

Current law's one class of stock restriction forbids issuance of preferred stock by an S corporation. The Bill approves "qualified preferred stock," sensibly treating dividends on it as interest, and defines the term as plain vanilla preferred stock "which is issued to a person eligible to hold common stock of an S corporation." Presumably the draft statute, new §1361(c)(8), does not mean precisely this—suppose the preferred stock was issued to a U.S. individual but subsequently transferred by her to a corporate investor—but the idea is both clear and welcome. It is in particular welcome because Congress, in a 1989 amendment to §351(a) that did not as I recall have the benefit of a public hearing, inadvertently rendered subchapter S unavailable, as a practical matter, in an important class of "assets and talent" incorporations.[1] The enactment of proposed §1361(c)(8) will correct the error.

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[1] Assume Ms. A is the proprietor of an enterprise worth in the neighborhood of $500,000. She agrees to incorporate the venture and to award Mr. B, the marketing manager, 25% of the voting common stock in exchange for his investment of $25,000. In the incorporation she will receive 75% of the voting common stock and $400,000 of senior securities. Here is the dilemma: If the senior securities are interest bearing debentures Ms. A under §351(b) is taxable on the receipt of them (subject only to possible installment reporting under §453) but the new company can qualify as an S corporation; if Ms. A instead receives preferred stock, under §351(a) she is not taxable but the new company under present law cannot qualify as an S corporation.

Perhaps the single most significant change the Bill proposes would allow an S corporation to operate through subsidiary corporations and, most importantly, to operate through 100 percent owned qualified subchapter S subsidiaries. A major inefficiency of current law, the mandate that an S corporation operate through divisions even though business exigencies urge the creation of one or many subsidiaries, would thereby be eliminated. The concept and the tax treatment of a qualified subchapter S subsidiary, in the Bill's proposed §1361(b)(3), undoubtedly derive from the concept and tax treatment of a qualified REIT subsidiary in § 856(i) of present law. But with this significant difference: A qualified REIT subsidiary must be wholly owned by the parent real estate investment trust throughout the subsidiary's existence, whereas a qualified subchapter S subsidiary may be acquired from prior owners and have an S corporation or C corporation history of its own. Under the Bill as under §856(i), the subsidiary is not treated as a separate corporation and, instead, all of its assets, liabilities, and tax attributes are treated as assets, liabilities, and tax attributes of the parent—in effect, the qualified subchapter S subsidiary for all tax purposes becomes a division of the S corporation. But the Bill does not tell us how this comes to pass.

The sensible answer, which ought to be explicit in the legislation, is that on the later of (1) the effective date of the S corporation's S election or (2) the S corporation's acquisition of 100 percent of the subsidiary's stock, the subsidiary is deemed to have completely liquidated in a transaction governed by §332, 334(b)(1), 337, and 381, and in which the S corporation, if the subsidiary was a C corporation, is deemed a transferee described in §1374(d)(8). Additionally, the shareholder loss limitation prescribed in §1366(d)(1) and the correlative basis adjustment provision in §1367(b)(2) should be revised (1) to make clear that debt of a qualified subchapter S subsidiary will be treated for purposes of these provisions as debt of the S corporation parent, and (2) to prescribe the order of basis adjustment when a shareholder holds debt issued by the parent, debt issued by the subsidiary, and debt on which the corporations are co-obligors.

My intention in raising technical concerns of this sort is not to discourage enactment of the proposed changes in S corporation eligibility. To the contrary, I favor all but the foreigners and tax-exempts. My point, rather, is that the Bill is in many respects an excellent start but it is not yet an excellent end.

A principal objective of S. 758, in addition to liberalizing the eligibility rules for getting into subchapter S, is to make it easier for an S corporation to maintain that status. Proposed desirable amendments to §1361(c)(2)(A) and particularly to §1362(f) are illustrative. So is the proposed and highly desirable repeal of §1362(d)(3), treating excessive passive investment income as a termination event, a repeal which in the Bill is packaged with modifications to and temporal extension of the §1375 excess passive investment income "sting tax." It is to the proposal to amend and, as amended, retain §1375 that I address two comments.

First, with excess passive investment income eliminated as an S termination event, is there adequate reason to retain (let alone extend) the "sting tax" penalty of §1375? In practice, the case to which the penalty tax applies is this one or a close variation:

> X has operated profitably for a number of years as a C corporation, accumulating substantial E&P. X has disposed of its historic business, paying the attendant §11 tax if any, and now has substantial cash to invest Mr. A, sole or dominant shareholder of X, holds his X shares at a low basis and, of advanced age, wishes to defer liquidation during his lifetime so that, upon his death, his estate will receive a stepped-up basis in the X shares and thereafter can efficiently liquidate X.

X now becomes an S corporation, invests its funds for dividend and interest yield, and annually distributes that income to Mr. A. If §1375 were not in subchapter S, Mr. A would pay individual §1 tax at a high rate but no other tax would be imposed. Section 1375 increases the aggregate tax burden on the investment yield, perhaps to penalize Mr. A for not promptly liquidating X, perhaps to penalize Mr. A for failing to cause X to invest in tax-exempt bonds and to accumulate the yield throughout the balance of Mr. A's life, perhaps to penalize Mr. A for living too long. Or perhaps §1375 persists to penalize Mr. A because he did not maintain in X corporation some activity which, however unnecessary and inefficient, annually generates sufficient "nonpassive" gross receipts to avoid altogether the §1375 penalty.

Section 1375 performs counter productively if, as the foregoing suggests, its impact is optional and its grasp readily avoided at a foolish but bearable inefficiency cost. Candor, I believe, urges that there are two comprehensible ways to deal with the E&P history of a corporation newly converted from C to S: Either (1) treat the S election as a taxable distribution of the accumulated E&P, or (2) forget penalties and tax the shareholder on actual E&P distributions at a full §1 rate but do not

tax the shareholder on corporate income, current or accumulated, at a greater than full §1 rate.[2] Section 1375 is not an efficient response to the accumulated E&P concern.

Second, if Congress does retain §1375, amended as the Bill proposes, there is I believe a technical problem of some size. Proposed §1375(b)(5)(A) changes the definition of "passive investment income" to exclude the fruits of sales and exchanges of stock or securities, and the "gain limitation" of proposed §1375(b)(4) does not apply to sales and exchanges of stocks and securities. The result, as I read the Bill, is that an S corporation to avoid §1375 can generate unlimited quantities of "nonpassive" gross receipts, at a relatively modest cost in brokerage fees, simply by buying many shares of publicly traded stock on Monday and reselling on the Monday following.

While S. 758 proposes a number of salutary changes in subchapter S, it hardly touches all bases. At least two additional reforms ought to be addressed.

First, under present law if an S corporation, at the time of a shareholder's death, holds appreciated property (such as cash method receivables and installment obligations) which property, if held directly by the decedent, under §1014(c) would not have been awarded a stepped-up (date of death) basis, the estate inappropriately achieves far better tax treatment solely because the appreciated property was lodged in an S corporation. The result is particularly inappropriate because, were the decedent's pass-through vehicle a partnership or LLC rather than an S corporation, under current law the correct rather than a "better" tax result would be achieved.[3] In Sec. 504(d) of H.R. 3419, the Tax Simplification and Technical Corrections Act of 1993, a simple and effective legislative cure was advanced. That bill was not enacted, for reasons unrelated to its substance, and unfortunately the stock basis correction did not make its way into S. 758. It should.

Second, there are important intersections of subchapter S and §453, the installment reporting provision, that deserve Congressional attention. An illustration, from S. 758 itself: Under proposed §641(d)(1) the portion of any "electing small business trust" which consists of stock in an S corporation is treated as a separate trust separately taxed, and the tax base of that separate tax is limited, essentially, to the trust's share of the S corporation's income plus any gain "from the disposition of stock in an S corporation." If an electing small business trust sells its S corporation shares for an installment note reportable under §453, there is no longer a portion of the trust which consists of S corporation stock and hence, under the proposed statute as written, there is no longer a separate trust to tax separately. What happens now?

This is not an isolated concern in subchapter S. For example, a qualified subchapter S trust ("QSST"), a creature of present §1361(d)(3), is an eligible S corporation shareholder; the QSST's income beneficiary and not the trust itself is taxed on the trust's share of S corporation income and on the proceeds of disposition of the S corporation shares.[4] If the trust sells its S corporation shares for an installment note, or if the S corporation sells its assets for an installment note and liquidates under §§453(h) and 453B(h), under the precise wording of §1361(d)(1)(B) it is doubtful, to say the least, that the beneficiary can report the gain on the installment method. But it is absolutely clear Congress did not intend that result. Additional illustrations of uncertain or unsuccessful subchapter S/section 453 interactions can be proffered—an example of an uncertain outcome in a case of substantial commercial significance is the sale of an S corporation's stock for installment obligations when the sellers and buyer jointly elect to report the transaction under §338(h)(10)[5]—but the main theme should be clear: Congress should undertake a careful reexamination of the availability of installment reporting when the shares or assets of an S corporation are sold for future payment.

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[2] As a conceptual matter the first choice, immediate taxation of all accumulated E&P, seems to me clearly superior. I so testified before the Ways & Means Committee on June 14, 1982, in the Hearings on H.R. 6055, the Subchapter S Revision Act of 1982. That testimony is preserved and expanded upon in *Subchapter S and Accumulated E&P: A Different View*, 17 Tax Notes 571 (1982). Congress rejected a C to S toll charge in 1982, and I see no greater likelihood of Congress embracing the concept in 1995. Hence my alternate suggestion that Congress simply drop § 1375 and its inherent inefficiencies.

[3] See *Quick Trust v. Commissioner*, 54 T.C. 1336, aff'd per curiam, 444 F.2d 90 (8th Cir. 1971); *Woodhall v. Commissioner*, 454 F.226 (9th Cir. 1972). The subchapter S stock basis issue and the proposed legislative reform are reviewed in detail in M. Ginsburg & J. Levin, Mergers, Acquisitions, and Buyouts § 1108.2 (Little, Brown & Co. 1995).

[4] See Rev. Rul. 92-84, 1992-2 C.B. 216, holding that the income beneficiary of the trust must recognize the sale gain even if under the trust instrument and local trust law sale gain is allocable to trust corpus and not to trust income.

[5] See Reg. §1.338(h)(10)-1(a), (d)(1)(ii), and (e)(2).

But is subchapter S reform an appropriate employment of Congressional time and resources when, more than a few argue, the small business world is rushing headlong toward LLCs? Will S corporations matter, will anyone use them, five years down the road? Even if S. 758 is good sensible tax legislation in the abstract, is this game worth the candle?

The answer seems to me clearly yes, and I would conclude this testimony by summarizing why I think this.

First, there are enormous numbers of existing S corporations and there are, or upon enactment of S. 758 will be, enormous numbers of C corporations that can elect S status. Virtually none of these corporations can convert to LLC status because, becoming an LLC, the corporation (whether C or S) is deemed for tax purposes to have completely liquidated. Corporate liquidation implicates corporate tax under §§1374 and 336, and tax at the shareholder level under §§1366 and 331. The tax toll charge, to convert from C or S to LLC, in the normal case is simply too high. Thus, for many many years we are going to have in the system tens-of-thousands of S corporations and hundreds-of-thousands of S corporation shareholders. They deserve better tax law than they now enjoy, and the enactment of S. 758, appropriately amended, will award it to them.

Second, some significant number of new enterprises and existing unincorporated enterprises—even some significant number of LLCs—will in future years elect to become S corporations. As S. 758 reminds us through its long awaited amendment of §1371(a), an S corporation is a unique pass-through entity in our tax law. Unlike a partnership or an LLC or a trust, an S corporation is a pass-through entity that can participate in a tax-free liquidation or reorganization with another S corporation or, most importantly, with a C corporation. If an LLC is merged into BigCo and in the exchange the LLC investors receive BigCo stock, they are taxable. If an S corporation merges into BigCo and in the exchange the S corporation shareholders receive BigCo stock, they are not taxable. It is as simple and as important as that.

Finally, more than tax law drives business decisions. LLCs are relatively new and they are different in different states. While many concerns have been sorted out and most others will be near term, some level of uncertainty will remain and some businesses and investors will prefer the familiar to the uncertain. The tax law should not through uncorrected statutory errors and omissions nudge taxpayers to one pass-through entity choice over another where, absent that unreasoned tilt, taxpayers would or might make the contrary choice.

Subchapter S, originated in 1958 and substantially revised and improved in 1982, is certainly one of the better segments of the income tax law. Although used by taxpayers and tax practitioners of widely varying levels of sophistication, the regime has produced, on balance, a remarkably low level of tax controversy. I believe this attributable in large measure to a tradeoff Congress endorsed at the outset and has adhered to consistently: The flexibility of special allocations and the participation of investors of every stripe, hallmarks of subchapter K, are traded away in subchapter S, exchanged for a simplified system in which neither the burdens of §§704(c) and 751 nor the benefits of §§752 and 754 nor the complexities introduced by tax-exempt and foreign investors play any part.

In future as in the past, I believe, investors anxious to achieve the flexibility and attendant tax benefits of subchapter K will disregard the S corporation, while many small businesses and investors disinterested in special allocations and complex basis adjustments and international involvements, but very interested in the tax simplification and attendant cost savings subchapter S affords, will continue to use the S corporation. A principal task of the Committee is to preserve and enhance that opportunity for the small business corporation and the small business investor.

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## Prepared Statement of Susan Pace Hamill

Mr. Chairman and Members of the Subcommittee:

My name is Susan Pace Hamill. I am an Assistant Professor of Law at the University of Alabama School of Law in Tuscaloosa where I teach Business Organizations and other advanced courses focusing on business entities. My research and scholarship concentrates on the taxation of and the business issues concerning limited liability companies (LLCs). Before joining Alabama's faculty in the Fall of 1994, I served as an attorney advisor in the Chief Counsel's Office of the Internal Revenue Service. My former division, Passthroughs & Special Industries, has jurisdiction over partnerships, subchapter S corporations, and LLCs. Before joining the Service in May of 1990, I practiced tax law for four years with the law firms of Sullivan & Cromwell and Chadbourne & Parke in New York City. I am here today on my own behalf and not on the behalf of any client or other group. Although my opinions

expressed today do not necessarily represent that of the Law School, I do appreciate the support of Dean Kenneth C. Randall and the University of Alabama Law School Foundation and the Edward Brett Randolph Fund that made it possible for me to be here today.

My testimony focuses on the need for and the benefits of S. 758, the "S Corporation Reform Act of 1995" (S Corporation Bill) a bill which, among other changes, substantially expands the availability of subchapter S by increasing the number and categories of persons that can qualify as shareholders while allowing S corporations to issue preferred stock to eligible shareholders. Rather than comment on the technical provisions of the Bill, the Subcommittee has asked me to address a broader question: Does the Tax Code need to expand the availability of subchapter S in light of the recent growth and acceptance of LLCs as an alternative form for doing business? After much thought and with full understanding of the inequities facing persons who choose S corporations, I believe that enacting legislation expanding subchapter S without fully allowing S corporations all the benefits of partnership taxation represents an inefficient use of resources because persons can receive even greater benefits with LLCs. Moreover, the proposed legislation adds another layer of complexity to the existing incomplete solutions to a much deeper problem with the taxation of business entities. My testimony examines the need for and the benefits of the S Corporation Bill in light of the existence of LLCs from two perspectives. First I will briefly recapture the rise of the LLC and discuss how Revenue Procedure 95-10's classification guidelines and Notice 95-14's proposal, allowing most unincorporated organizations to elect partnership or association taxation, illustrates an acceptance of LLCs, making the S Corporation Bill largely unnecessary. I will then briefly discuss the root problem, many organizations with essentially the same business characteristics receive disparate tax treatment, at the foundation of the corporate and partnership tax regimes and illustrate that the S Corporation Bill at best offers slight improvements at the margin of this problem.

## I. THE AVAILABILITY AND ACCEPTANCE OF LLCS

Within a relatively short period of time, the availability and use of the domestic LLC exploded out of obscurity into the mainstream of American business. A LLC is an unincorporated organization that for the first time domestically offers limited liability for all members combined with the ability to be treated as a partnership for federal income tax purposes. The partnership taxation provisions offer many advantages including the ability to incur only one level of tax at the partner level and flexibly allocate the partnership's profits and losses. The LLC's business features can be best described as between the traditional corporation and the traditional partnership. Many characteristics, such as the limitations on transfers of ownership interests, direct management by the members under agency law and an institutionally transitory nature because of dissolution possibility upon a change in one of the original owners, clearly reflect partnership law. However the ability to vest management powers in managers and change the transferability and dissolution provisions by agreement allows LLC members to adopt desired features of corporate law.

In 1988, when the Service first recognized the LLC's right to be classified as a partnership for tax purposes, only Wyoming and Florida had LLC statutes. LLCs experienced a slow cautious growth from 1988 until the close of 1991. In 1990 two states, and in 1991 four states, passed LLC statutes. In 1992 and 1993 LLC legislation grew substantially. By the close of 1992 ten more states including Delaware had passed statutes. In 1993 eighteen more states recognized LLCs and by the close of 1994 almost all remaining states, including New York and California, had passed statutes. The three states without statutes, Hawaii, Massachusetts and Vermont all have LLC legislation pending in their legislatures, making it highly likely that all states will recognize LLCs by the end of 1995 or 1996. Moreover in August of 1994 the National Conference of Commissioners on Uniform State Laws approved the final reading of the Uniform Limited Liability Company Act.

In 1989 while I was still in private practice I published a detailed article on LLCs, "The Limited Liability Company: A Possible Choice For Doing Business?," in the Florida Law Review. In the Spring of 1990 when I first joined the Service the LLC was still a relatively new form that many persons had never heard of. During my four years of government service, I participated in the review of many state statutes before enactment, served as an advisor to the National Conference of Commissioners on Uniform State Laws when they were drafting the Uniform LLC Act and worked on earlier drafts of Revenue Procedure 95-10 before its publication. In addition to participating in many formal panels and other speaking engagements addressing LLC issues, I attended many meetings of LLC committees organized by the Tax and Business Sections of the American Bar Association.

Based on my experience from working with the state LLC drafting committees, members of the American Bar Association and other groups, as well as talking to numerous practicing lawyers, the rise of the LLC can be explained as state law crafting a new form to fill in gaps left open by traditional partnership and corporate statutes. Persons doing business wanted a way to directly obtain limited liability protection combined with partnership tax treatment with the flexibility to structure business arrangements without some of the limitations and complications that have plagued many close corporations. Once a few states caught on to the idea and the Service ruled in favor of partnership status, the rapid rate in which the other states enacted LLC legislation can be viewed as either a "race to the top" or "a race to the bottom" (a metaphor first used to describe the enactment of the first corporate statutes), depending on your view of LLCs. Once a few states offered the opportunity to form LLCs in that jurisdiction, the other states needed to provide that same opportunity to avoid losing new filings and business.

In 1993 the Service started regularly issuing state-by-state LLC revenue rulings providing formal guidance that each statute met the partnership classification rules. In early 1995 the Service issued Revenue Procedure 95-10 which essentially equates LLCs as limited partnerships for purposes of applying the classification rules and therefore creates the same gateway to partnership taxation for LLCs that limited partnerships have long enjoyed. To be classified as partnerships, LLCs (like all other unincorporated organizations) must lack two of the four corporate characteristics—continuity of life, centralized management, free transferability of interests and limited liability. When applying the partnership classification tests for lacking continuity of life, free transferability of interests, and centralized management, Revenue Procedure 95-10 essentially treats LLC managers as general partners of limited partnerships and grants LLCs even more flexibility than limited partnerships if the LLC attempts to lack limited liability.

For example, rather than the bankruptcy of all members triggering a possible dissolution, LLCs like limited partnerships can trigger a possible dissolution (requiring an agreement to continue to avoid the dissolution) upon the bankruptcy of the managers only. The ability to focus on the managers while still lacking continuity of life allows LLCs to maintain almost the same amount of business stability as limited partnerships while still meeting the requirements for lacking continuity of life. LLC managers, like general partners of limited partnerships, can now provide the required consent for a complete transfer of an interest with the LLC still lacking free transferability of interests. With an LLC any member can potentially assume all the LLC's liabilities causing the LLC to lack limited liability. LLCs with managers, like limited partnerships, can lack centralized management if a number of requirements are met.

Although some technical aspects still must be worked out, for example the requirement that the assumption of all the LLC's liabilities be pursuant to express authority granted in the controlling statute which in the long run will pose more problems for foreign rather than domestic LLCs, Revenue Procedure 95-10, represents a significant breakthrough in the ability to use the LLC. Because LLCs are accorded almost the same flexibility limited partnerships enjoy for purposes of meeting the classification rules, those rules should play a minimal role and business considerations should primarily govern whether or not the participants choose an LLC. If the tax policymakers adopt the proposal set out in Notice 95-14 allowing unincorporated businesses to elect partnership tax treatment without regard to the technical classification rules, LLCs will become an even more attractive choice because business participants will no longer have to be concerned with complying with the requirements of Revenue Procedure 95-10.

My most recent article, "The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case For Eliminating the Partnership Classification Regulations," takes the position that domestic LLCs and limited partnerships should receive automatic partnership taxation under either a "check-the-box" approach, consistent with the Service's proposal in Notice 95-14 or a per se approach which would always classify them as partnerships similar to the current per se taxation of domestic corporations. The article argues that these regulations should be eliminated because they fail to draw the line between associations and partnerships based on meaningful business distinctions. Moreover because the application of the classification regulations fail to increase revenues, those regulations actually cost the government money by increasing administrative transaction costs for the Service and also increase costs to taxpayers that need to seek advice. This article appears in the Spring 1995 edition of the F.Hodge O'Neal Symposium on LLCs in the Washington University Law Quarterly.

The release of Revenue Procedure 95-10 and the possibility of the classification regulations being eliminated as illustrated by Notice 95-14 illustrate that the in-

creased use and acceptance of LLCs makes the S Corporation Bill largely unnecessary. Over the next several years a substantial number of new businesses will likely choose to use LLCs instead of closely held corporations.

Even with the increased number and kinds of persons that can be S corporation shareholders, subchapter S still fails to offer the flexibility of subchapter K which imposes no limits on how many and the kinds of persons that can be partners or members of LLCs. The ability of an S corporation to issue preferred stock, treated as interest, offers only slightly more flexibility to allocate the economic wealth of the business when you compare that to the ability under subchapter K to make special allocations. Partners and members of LLCs can agree to allocate the partnership's or LLC's items of income, gain, loss, deduction or credit in any manner they choose so long as the tax allocations correspond to how the partners or members share the economic profits or bear the economic losses.

Because the LLC offers all the benefits of partnership taxation combined with the limited liability of a corporation, with or without the S Corporation Bill new businesses will largely choose the LLC. Moreover the treatment of LLCs for business purposes will likely develop in a fashion that makes the LLC a better choice than the close corporation for reasons totally independent of tax considerations. The development of the close corporation including both special close corporation statutes and the law interpreting shareholder agreements, illustrates the difficulty of applying traditional corporate business law to closely held corporations. Allowing LLC members to either treat all members as agents similar to general partners or provide for manager-managed LLCs without the inflexible rules associated with a corporate board of directors causes the LLC business provisions to adopt the best of both worlds from the corporate and partnership provisions at least when focusing on the needs of closely held businesses.

If future new businesses likely choose to form as LLCs rather than closely held corporations benefitting from the S Corporation Bill, the inevitable resources associated with any new legislation will be wasted. Some of these resources include, for example, the staff that must write the legislative history, the staff of the Treasury and the Service that must issue regulatory and other guidance and the lawyers and accountants that must interpret both the legislation and the guidance for their clients. Even if the S Corporation Bill theoretically represents good tax policy it fails to be a sound practical investment if a large majority of businesses migrate toward LLCs instead of closely held corporations.

## II. CRUCIAL PROBLEM BEHIND BUSINESS TAXATION REMAINS UNSOLVED

Under current United States tax law, a business conducted as a corporation will per se be subject to the corporate tax regime regardless of its business characteristics. The corporate tax regime imposes a "double tax" on all corporations. The corporate tax applies to all of the corporation's net income and the shareholders are taxed again when they receive dividend distributions.

To avoid the effects of the double corporate tax, closely held corporations must either elect subchapter S or engage in self help techniques such as paying out all profits in deductible items. Unincorporated forms such as partnerships and LLCs receive the benefits of partnership taxation, that offer substantially more advantages over subchapter S even with the S Corporation Bill, by complying with the formalistic requirements of the partnership classification regulations that carry no substantive business meaning.

Regardless what form the participants choose, closely held businesses often share very similar business characteristics. The development of the close corporation business law involved borrowing partnership concepts either by providing special close corporation supplements or by allowing the existence of shareholder agreements. Arguably the existence of two extremely different tax regimes, the corporate and partnership provisions, applying to businesses with the same characteristics produces intolerable inequities. On a superficial level the S Corporation Bill is very appealing because it takes small steps to mitigate these inequities. By loosening up the shareholder limitations, allowing preferred stock and making other changes, the S Corporation Bill makes subchapter S slightly more attractive than it was when comparing it to the partnership provisions. However when you consider the resources that must be expended to implement any new legislation, the changes offered by the S Corporation Bill which at best make improvements at the margin are ultimately not worth the price paid.

My position today concerning the S Corporation Bill as well as my position in the Washington University Law Quarterly article arguing for elimination of the classification regulations should not be interpreted as support for the current system of taxation for business entities. I believe that the current regime for taxing business

entities, the corporate double tax applying to corporations, with the opportunity to elect subchapter S or engage in self help techniques by paying out corporate earnings as deductible items, and the flexible flow-through rules applying to partnerships and LLCs, contains serious flaws. The current system results in many businesses with very similar characteristics receiving vastly different treatment under the Internal Revenue Code.

Although the S Corporation Bill may seem appealing when viewed in isolation, the administrative costs of implementing this new legislation will greatly outweigh the benefits of providing slightly more fair treatment to S corporations. The changes at best offer slight improvements when comparing the benefits of subchapter S and the partnership provisions. Moreover, new businesses will likely choose the LLC over the closely held corporation in order to avoid the inequities of the corporate tax regime as well as for business reasons. Arguably the vastly different results offered by the corporate and partnership provisions should not arbitrarily apply based on the form chosen if the business has similar characteristics. However only a careful and complete resolution of the corporate integration question rather than the piecemeal attempt as reflected in the S Corporation Bill can address this fundamental problem.

I plan to write a follow up article to the Washington University Law Quarterly piece exploring the fundamental problem of different tax regimes applying to similar businesses and the relationship between the increased use of LLCs and the corporate integration issue. Some commentators have claimed that LLCs allow state law sanctioned corporate integration without Congressional approval. Although such an argument may seem superficially appealing, my follow up article will illustrate that LLCs do not create a "back door" to corporate integration. LLCs simply provide a direct, more transaction cost free, route to obtaining limited liability protection and one level of taxation. Persons who can afford expensive advice have always been able to structure their business in a manner that obtains these benefits indirectly. Although I strongly urge the tax policymakers to address the broader concern of disparate tax treatment applying to essentially equivalent business entities and offer any assistance by sharing the findings of the follow up article, I do not believe in its current form the S Corporation Bill sufficiently addresses this crucial problem to justify the costs of implementation.

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## PREPARED STATEMENT OF GLEN A. KOHL

Mr. Chairman and distinguished Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Administration on the provisions in S. 758, the "S Corporation Reform Act of 1995" (the "Reform Act") and the proposal in H.R. 1215 to change the rules for claiming expenses for the business use of a home.

The Administration supports the goal of the Reform Act to provide small business with needed S corporation reform and simplification. We are concerned, however, that the Reform Act, if enacted in its current form, would create undue complexity and increased opportunities for large regular corporations (C corporations) to escape corporate taxation. Accordingly, we would like to work with the Committee to develop a reform package that is more precisely targeted to small business and does not introduce additional complexity into the Code.

With regard to the proposal for permitting deductions for home offices (the "Home Office Proposal"), we generally support the proposal. We believe the law should be revised to reflect changes in the workplace. Here too, however, we would like to work with the Committee to make sure the language is drafted so as to minimize the potential for abuse and associated audit difficulties. We would also be interested in working with the Committee to address the effect of the proposal on the tax treatment of daily transportation expenses.

Finally, we believe that appropriate revenue offsets must be provided for these legislative proposals to the extent they lose revenue.

### A. S CORPORATION REFORM ACT OF 1995.

Let me first address the S Corporation Reform Act. By way of background, I should mention that this Administration frequently champions legislation specifically targeted at assisting small businesses. For example, in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), the Administration supported the change which increased the maximum amount of capital investment that small businesses can expense under Section 179 from $10,000 to $17,500. In fact, we had proposed a greater increase and only settled for the $17,500 figure that was ultimately enacted. We continue to support, on a revenue neutral basis, legislation that would

increase expensing for small businesses. This tax benefit applies to all small businesses, regardless of form, and not merely those that are conducted as S corporations.

Similarly, the President last week announced a number of proposals that would make it easier for all small businesses to establish retirement plans for their employees. One of the President's proposals, the National Employee Savings Trust or "NEST" proposal, is specifically designed for businesses with fewer than 100 employees. We look forward to working with the Committee on this proposal.

In addition to supporting legislative proposals that are targeted to small business, Treasury regularly issues administrative guidance that assists small business. For example, under current law, taxpayers intending to conduct business in a flow-through partnership must comply with a multi-factored test that is both complex and uncertain in its application. We recently issued Notice 95-14, 1995-14 I.R.B. 7, suggesting a proposal that would replace this system and permit taxpayers to elect to be treated as a partnership simply by checking a box on a return. If adopted, this check-the-box approach would replace the current rules and eliminate needless administrative and compliance costs to taxpayers seeking partnership treatment. This proposal has been uniformly praised by taxpayers and tax practitioners.

We have also recently published guidance that, prior to the adoption of a check-the-box system, will provide more certainty under the current rules for taxpayers seeking partnership status for limited liability companies or "LLCs." LLCs combine the flexibility of partnerships with the liability protection of S corporations. Consequently, LLCs are becoming the entity of choice among new enterprises in many situations.

Finally, we have also issued guidance that specifically addresses S corporation issues. For example, we recently revoked a 1977 ruling that cast doubt on an S corporation's ability to enter into a partnership in certain circumstances and have explicitly provided that S corporations can enter into partnerships with partners that could not qualify as S corporation shareholders, including nonresident aliens. Rev. Rul. 94-43, 1994-2 C.B. 198; Income Tax Regulation §1.701-2(d), Example 2. This guidance administratively furthers some of the goals of the Reform Act by providing S corporations with more flexibility to raise additional capital and structure their business relationships as required.

We share the desire of the sponsors of the Reform Act to assist and strengthen small businesses. We believe, however, it is necessary to ensure that the goals of the legislation are achieved most efficiently and that the primary beneficiaries will in fact be small businesses.

The tax landscape has evolved significantly since the S corporation reform effort began in earnest in the early 1990's. For example, as I mentioned earlier, LLCs have recently become a tremendously popular alternative to S corporations. As of 1995, LLC legislation has been enacted in almost every state and the proposed check-the-box system is on the horizon. While these developments do not eliminate the need for certain reforms that would be useful for existing S corporations, they do require a reassessment of who will benefit from any S corporation proposal. We also should make sure we do not add undue complexity to the S corporation regime.

Many of the technical and administrative provisions of the Reform Act are simply good government and we support such provisions. These include, for example, the rules that grant the IRS the authority to treat flawed elections as valid and certain other proposals. We also support the proposal to increase the number of shareholders from 35 to 50. Nevertheless, we are concerned that certain other aspects of the Reform Act, when coupled with current law, will unduly benefit large C corporations, rather than the intended beneficiaries of the Act.

We base our concerns on a variety of factors, including the fact that under current law regular C corporations seeking flow-through tax treatment can frequently escape most corporate level taxes simply by electing S corporation status, assuming the applicable requirements are satisfied.[1] In particular, corporate taxes on current income are generally eliminated and a tax on any net built-in gains can be avoided by deferring any sales of built-in gain assets for ten years. In this regard, S corporations have a distinct advantage over other flow-through regimes such as partnerships. If a C corporation enterprise chooses to conduct business as a partnership (including an LLC taxable as a partnership), it would generally incur, in addition to

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[1] Exceptions to nonrecognition on conversion include LIFO recapture for C corporations that use the LIFO method and, for C corporations with earnings and profits, a corporate-level tax on any recognized "excess net passive investment income" under section 1375.

a shareholder-level tax, a corporate-level tax on net built-in gains. This "toll charge" tax reduces the erosion of the existing corporate tax base.[2]

We are concerned that one consequence of the Reform Act's expansion of the eligibility requirements is that it will enable an increasing number of large C corporations to avail themselves of the S election to escape corporate level taxes. We expect that if the Reform Act becomes law, large C corporations will take advantage of the new rules. The Administration believes that legislation intended to benefit only small business and existing S corporations should do just that.

In short, the Administration supports the goals of S corporation reform, but believes that it should be more carefully tailored to its objectives and should avoid undue complexities. We would be pleased to work with the Committee to develop an S corporation reform package that meets these criteria.

B. MODIFICATION OF HOME OFFICE DEDUCTION FOR ADMINISTRATIVE AND MANAGEMENT ACTIVITIES

We generally support the Home Office Proposal. It is important for the tax law to keep pace with the changes in the workplace, and we believe that reform in this area is appropriate.

The proposal would amend the Internal Revenue Code so that a portion of the taxpayer's home would qualify as a "principal place of business" if (i) the office is used by the taxpayer to conduct administrative or management activities, and (ii) there is no other fixed location where the taxpayer actually conducts substantial administrative or management activities. By contrast, under current law, a deduction is generally allowed with respect to the use of a taxpayer's residence only in limited circumstances, including *where a portion of the home is exclusively used on a regular basis as the taxpayer's "principal place of business."*[3] Thus, under the bill, a home office deduction would be allowed under circumstances where the taxpayer's home, under current law, is not the taxpayer's principal place of business.

While we believe this result is appropriate in many cases, certain considerations should be addressed. In particular, the current rules were enacted by Congress in 1976 to reduce the substantial amount of litigation over the circumstances under which a taxpayer who worked in his or her home could deduct as a business expense a portion of the costs associated with maintaining the home. It is important that we make every effort to avoid turning back the clock and creating a level of ambiguity that would result in more disputes between taxpayers and the IRS. To address this concern, we believe modifications to the statutory language are needed.

We are also concerned about the potential implications of the Home Office Proposal for daily transportation expenses. As currently drafted, the bill would affect more than home office deductions. It would also permit deductions for currently nondeductible commuting expenses and create considerable uncertainty in this area. We believe the effects of the Home Office Proposal should be limited to home office expenses. This issue also can be addressed through drafting revisions.

In summary, we support the Home Office Proposal and would be pleased to work with the Committee to address the concerns we have raised.[4]

Mr. Chairman, this concludes my testimony, and I would be pleased to answer any questions that you or other members of the committee may have.

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PREPARED STATEMENT OF DR. JUDITH OBERMAYER

Chairman Orrin Hatch, Ranking Member John Breaux, and Subcommittee members, thank you for inviting me to testify today on the issue of the home office tax

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[2] We note that the staff of the Joint Committee on Taxation recommended, as part of a simplification package, that "a shift from C corporation status to passthrough entity status where the passthrough entity is an S corporation [be] conformed to the present-law treatment where the passthrough entity is a partnership." See letter to Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, reprinted in Committee on Ways and Means, *Written Proposals on Tax Simplification*, WMCP 101-27, May 25, 1990, p.20.

[3] A deduction is also allowed for a portion of a home that is exclusively used on a regular basis (i) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's trade or business, or (ii) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

[4] Section 6354 of H.R. 1215 would allow a deduction for expenses related to a storage unit in the taxpayer's home used for product samples if he or she is engaged in the business of selling those products at retail or wholesale and the home is the sole fixed location of the taxpayer's business. This proposal simply extends a current-law rule for inventory to product samples. We have no objections to this proposed change.

deduction. My name is Judith Obermayer, owner of Obermayer Associates, a home-based business located in West Newton, Massachusetts. I am here to testify today as Chairman of the Board of Directors for the National Association for the Self-Employed.

Over the last several months, I have had the pleasure of serving as the chair of the Massachusetts delegation to the White House Conference on Small Business (WHCSB). The WHCSB can be best described as a process which involved meetings in all 50 states over a 15 month period culminating in last week's national conference. Nearly 2,000 small business persons from all 50 states served as delegates to last week's conference. I am pleased to inform the committee that home office deduction reform is one of the major policy recommendations adopted by the WHCSB.

As the operator of a home-based business, I provide financial and management consulting services to high technology companies. My firm helps these companies develop business plans and strategies for raising money to fund business expansion. Of significance, many of these high technology companies started out as home-based businesses.

The NASE represents over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting and retail fields. The home office deduction is extremely important to the NASE. We project, based on a recent survey, that about 60 percent of our members operate home-based businesses.

The NASE commends the Finance Committee for its leadership on issues critical to the small business community. We want to particularly thank Chairman Orrin Hatch for his introduction of S. 327, the Home Office Deduction Act. The legislation has strong bipartisan support. Finance Committee members Max Baucus and Charles Grassley should be commended for having joined Senator Hatch as original sponsors of S. 327; and similarly, Committee members John Chafee and Alfonse D'Amato for their cosponsorship of the initiative. S. 327 is conceptually similar to the home office deduction provisions contained in the recently passed House tax bill—H.R. 1215, the Contract With America Tax Relief Act of 1995.

## HOME-BASED BUSINESSES IN THE 1990'S

Home offices have become a central feature of today's American economy, a phenomenon which has been influenced by several factors. First, the U.S. economy is rapidly becoming more and more service and information-based. Second, companies are re-engineering their work places to increase productivity. These firms are tapping into the desires of workers to use modern telecommunications tools and work where it is most convenient. Often that means working at home. The 1989-1992 recession accelerated these trends and provided a means for workers to go it alone, if necessary, through the operation of home-based businesses.

Everyone is familiar with the phrase "Massachusetts Miracle," which was used to refer to the business climate in my state of Massachusetts prior to the 1989-1992 recession. In the middle to late 1980's, my state was booming economically. Computer companies, such as Digital, Prime, and Wang Corporations, were selling high technology products throughout the United States; and as a result, were hiring thousands of new workers to fill office and factory buildings along Boston's famed Route 128 corridor. Real estate, and banking and financial institutions—like Fidelity Investments—were booming as well in the 1980's.

By 1989 the Massachusetts Miracle was no more. The recession resulted in the layoff of tens of thousands of workers in my state. The downsizing of Massachusetts' computer companies and financial institutions involved the layoff of blue-collar individuals—and highly skilled persons such as engineers, marketing and sales representatives. Unemployment for these people often meant that starting a home-based business was their only option for finding a "job."

In testifying about home-based businesses today, the NASE is calling on Congress to overturn a 1993 U.S. Supreme Court decision (described in greater detail below) which dramatically cut back on the availability of the home office tax deduction. The home office deduction is not a tax incentive for the wealthy. It is a deduction important to (among others) consultants of all types, private nurses, independent sales representatives, plumbers, and persons in the construction trades. With the development of new technologies (such as facsimile machines, modems, personal computers, etc.) home-based businesses have become extremely popular because they make sense to the work force of the 1990s.

According to a 1994 survey by the LINK Resources Corporation, over 43 million people now do some portion of their work at home, a figure which includes self-employed persons, telecommuters, and individuals with employee status. Based on the

number of 1993 tax returns reporting the payment of federal self-employment tax, there are about 12.4 million self-employed individuals in the United States.[1] Over 7 million people operate home-based businesses.[2]

By fostering home-based businesses, Congress would be taking steps to increase productivity and spur economic growth. Home offices are popular in the 1990's because they make sense for businesses, families, and individuals.

WOMEN ENTREPRENEURS AND HOME-BASED BUSINESSES

Women have a significant stake with respect to the issue of home office deduction reform. Of the over 5 million women business owners in the United States, 54.6 percent operate home-based businesses.[3] Even more noteworthy, while women own about 30 percent of all businesses, some estimates indicate that women are currently forming twice as many businesses as men are.[4]

The corporate downsizings, occurring both in my state and throughout the country, have put tremendous pressure on the lifestyle of the average American family. This situation has resulted in fewer jobs being offered through large companies. It has become an issue of necessity for both spouses to work in order to make "ends meet" for many American families. Home-based businesses have grown in importance, in part, both as a response to these corporate downsizings and as a means of providing work force flexibility. A home business provides one spouse with the option of staying home with the children and the ability to earn an extra income at the same time.

While work force flexibility may have been the traditional reason given as to why a woman started a business, it is not the only factor for a woman in today's economy. The women executive in the typical large U.S. corporation interfaces daily with a senior management work force predominantly composed of men. This situation has created a "glass ceiling" for many women executives in these large companies. Accordingly, many of these same women have turned their interests to starting a small business. They often view starting a small business as a sense of expression—and as way of fostering personal growth for their professional and business careers.

OLDER WORKERS

A major facet of the corporate downsizing process is that older workers are increasingly finding it more difficult to find another job, particularly as many companies appear more attuned to hiring workers at lower salaries. Home businesses offer the nation's older workers with an excellent way of reentering the work force; and for those for whom it is important, the flexibility to work part-time.

S. 327, THE HOME OFFICE DEDUCTION ACT

The NASE strongly supports the home office deduction provisions of S. 327. These provisions provide much needed clarification to the small business community regarding the availability of the home office deduction. Among other objectives, the legislation provides for reform of the home office tax deduction in light of the 1993 U.S. Supreme Court decision in the *IRS Commissioner* v. *Soliman* case. This case substantially narrowed the availability of the home office deduction to America's small business community.

In the aftermath of the 1993 *Soliman* case—tens of thousands of owners of home-based businesses found themselves disenfranchised from taking a legitimate business deduction on their tax return. For this reason, within weeks of the public release of this 1993 Supreme Court decision, the NASE began building a coalition of associations supporting legislation to overturn the court decision. Over 30 associations have joined the NASE in this effort, a coalition representing over 2 million businesses in the United States.

THE IRS COMMISSIONER V. SOLIMAN DECISION

In order to be eligible for a home office deduction under Internal Revenue Code Section 280A(c), the business owner must use the office on an exclusive and regular

[1] IRS Statistics of Income, preliminary (unpublished) 1993 individual income tax return statistics.

[2] The State of Small Business: A Report of the President, U.S. Small Business Administration, 1993, page 336. While Footnote 1 is based on IRS statistics of income data, the State of Small Business Report information utilizes Congressional Budget Office data.

[3] Ibid., page 349. Also see Seglin, Jeffrey L., "The Best Little Advocacy Group In America," Inc. Magazine, May 1994, page 25.

[4] Brush, Candida G., "Research On Women Business Owners: Past Trends, a Perspective and Future Directions, Entrepreneurship: Theory and Practice, Summer 1992, page 5.

use basis, and the office must either be (a) his principal place of business; (b) the place where he meets or deals with patients, clients, or customers in the normal course of his trade or business; or (c) a separate structure which is not attached to the dwelling unit. Moreover, a person claiming a home office deduction may not claim a deduction for more than the revenues of the business (in other words, a $100 deduction can not be claimed when business revenues amount to only $50).

The *Soliman* decision revolves around the definition of "principal place of business." Under this U.S. Supreme Court holding, an anesthesiologist was found not to be entitled to a home office deduction because the doctor's principal place of business was determined by the court to be the hospitals where the doctor performed services for patients. The court ruled in this fashion even though the anesthesiologist saw patients in several hospitals, none of which provided him with an office. The doctor contacted patients, set up appointments, did billings, and kept his business records at the home office.

The U.S. Tax Court and the U.S. Ninth Circuit Court of Appeals ruled in favor of the doctor. Seeking to overturn the pro-taxpayer decisions of the lower courts, the IRS appealed the *Soliman* case to the U.S. Supreme Court. It was a surprise to many people that the Supreme Court ultimately reversed the lower court decisions in favor of the IRS by disallowing Soliman's home office deduction.

Mr. Leslie B. Samuels, Assistant Treasury Secretary for Tax Policy, testified before the House Ways and Means Committee on January 10, 1995 regarding the home office deduction and other provisions contained in the Contract With America. In describing the Soliman decision, Mr. Samuels stated, "[T]he Supreme Court held that the principal place of business should be defined to include only the place of business where the activities most crucial to the operation of the business occur . . . For example, activities crucial to certain service businesses require personal contact with customers outside the service provider's home office. In such cases, the home office would not be regarded as the principal place of business, even if no other principal place of business existed."

In effect, the Supreme Court seems to be requiring two new tests in order for an individual to qualify for the deduction. The court decision effectively requires (1) the customers of a home business to physically visit the home office and (2) that the business income be generated within the home office itself—not from transactions that occur outside the home office.

The NASE firmly believes the holding in the *Soliman* case to be extremely shortsighted—especially since the decision ignores the way business is conducted today. Offices have changed dramatically in the last twenty years. That is, personal computers, facsimile machines, computer networks, and overnight delivery services have made it unnecessary to bring customers through the home office. The holding is also shortsighted as local zoning ordinances often prohibit home-based businesses from bringing customers to the home office.

The *Soliman* decision creates significant problems for a broad range of industries and professions. The list of people potentially losing the deduction includes independent sales representatives, plumbers, electricians, remodeling specialists, home builders, veterinarians, travel agents, and others. Now, as a result of *Soliman,* these business persons must effectively bring their customers through the home office in order to qualify for the deduction.

### THE RECORDKEEPING AND BOOKKEEPING FUNCTIONS OF THE BUSINESS

By holding that the home office must itself generate revenue, the *Soliman* decision effectively treats the administrative activities of the business as unimportant. That is, the *Soliman* holding serves to minimize the importance of the recordkeeping and bookkeeping functions of the business, as well as its tax and regulatory compliance activities. Ironically, it is the government itself, notably the IRS, which generates the demand for many of these activities.

This problem is clearly addressed by S. 327. The entrepreneur's home office would qualify under the Act as a principal place of business (and thus, be eligible for the home office deduction) if: (A) the taxpayer conducts his essential administrative or management activities at the home office; (B) such activities are conducted at the home office on a regular and systematic basis; and (C) the home office is the only office utilized by the business person.

S. 327 shows an appreciation for the conveniences home-based businesses offer American families. A home-based business provides a spouse (including a single parent) the emotional benefits of taking care of his or her children at home while earning money at the same time. In addition, as described above, the measure is an excellent response to the current spate of corporate downsizings which have resulted

in the layoffs of tens of thousands of workers. They, like many other people, are now attempting to live the American dream by starting businesses out of their homes.

STORAGE OF PRODUCT SAMPLES

Internal Revenue Code Section 280A(c)(2) permits an independent sales representative and others to generally take a home office deduction for the space used on a regular basis in the home with respect to a storage unit of inventory held for resale. This sales person is eligible for the home office deduction—under the Code provision—as long as the dwelling unit is the only location of his trade or business.

Section 3 of S. 327 modifies Code Section 280A(c)(2) by expanding the definition of a storage unit to include a place where product samples may be stored. The NASE views Section 3 as a positive measure for small business. We believe the measure will contribute to economic growth by fostering the sale of products at the retail and wholesale levels. In conclusion, the NASE strongly supports the home office deduction provisions of S. 327. We look forward to working with the Senate Finance Committee to ensure enactment of these important provisions for small business.

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PREPARED STATEMENT OF SAMUEL P. STARR *

INTRODUCTION

The American Institute of Certified Public Accountants (the AICPA) strongly supports S. 758, the S Corporation Reform Act of 1995, and is pleased to provide these comments to the Subcommittee for inclusion in the hearing record. The reform of subchapter S of the Internal Revenue Code (the Code) is a tax issue of high priority for the 320,000-member AICPA, which has taken a leadership role in the recent reform effort from the beginning. We thank Chairman Hatch and Senator Pryor for introducing this important legislation and applaud the Subcommittee for being the first Senate body to provide a public forum on the bill.

The AICPA's 320,000 members include many of the tax practitioners who prepare tax returns for and provide planning advice to the 1.9 million businesses, most of which are small businesses, that are organized as S corporations. Our members know first-hand the restrictions imposed and the complexities encountered under the current S corporation tax laws. This practical exposure to the real-world situations that face small businesses today convinces us that it is time to amend the tax Code to better reflect the business realities of the 1990s, simplify tax compliance for S corporations, and enhance capital availability for America's small businesses. S. 758 achieves these important and laudable goals and the AICPA is proud to voice strong support for the bipartisan legislation.

Enactment of the S Corporation Reform Act of 1995 would make S corporations more useful and flexible by expanding capital formation techniques, preserving family-owned businesses, reforming S corporation fringe benefit treatment, and removing undesirable tax traps. S. 758, if enacted, would amend the Code to allow small businesses to keep pace with the realities of modern business.

BACKGROUND

Subchapter S was first enacted in 1958 to help remove tax considerations from small business owners' decisions to incorporate. Electing "subchapter S corporations" (as they then were called) were not subject to the classic two-tier tax system, which applied to non-electing corporations. This tax treatment was beneficial to small businesses, especially start-up businesses. Subchapter S, as originally enacted, however, was very limiting and contained a number of pitfalls and traps for the unwary.

It was not until 1982 that subchapter S became popular. In that year, after a multi-year, collegial effort on the part of the AICPA, members of the American Bar Association's Section of Taxation, and the staff of the Joint Committee on Taxation, subchapter S was substantially revised to remove many of its traps and some of its obsolete restrictions. Subsequently, changes made in the Tax Reform Act of 1986 made the election of subchapter S treatment highly desirable to many small businesses. Today, there are 1.9 million businesses,[1] more than 48 percent of corporate

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* On behalf of Deborah Walker, Chair of the AICPA Tax Executive Committee.

[1] These figures are for 1993, the most recent year for which data is available. See "Table 1.—Number of S Corporation Returns Relative to All Business Returns," *Joint Committee on Taxation Staff Description (JCS-16-95) of Present Law and Proposals relating to Subchapter S Cor-*

tax return filers,[2] that are S corporations. In short, both the tax system and the small business community have benefited from these efforts.

THE LEGISLATIVE PROPOSAL

Now, more than a decade after the enactment of the Subchapter S Revision Act of 1982, we ask that you modernize subchapter S to bring S corporations more on a par with partnerships and C corporations (those corporations without a subchapter S election in effect). The AICPA, along with the U.S. Chamber of Commerce and members of the American Bar Association's Section of Taxation, helped develop the provisions of S. 758. We are confident that the legislation represents good tax policy and urge the Subcommittee to endorse the measure.

A small business today does not operate the way a small business did in the 1950s. We believe subchapter S should be amended to better reflect this reality. The financial environment is far more complex in the 1990s than it was in the 1950s, and current legislative restraints are handicapping small businesses. Many of the prohibitive restraints currently in subchapter S date back to its original enactment in 1958, when times (and financial transactions) were much simpler.

Subchapter S requires a fresh outlook for the 1990s and beyond! The current rules are antiquated in many respects and, as a result, S corporations face obstacles and limitations not imposed on other forms of entities. As would any business seeking to survive into the 21st century, S corporations want to update their operations and the rules that govern them.

For instance, with the traditional sources of debt financing commercial banks presently restricting their loans to small businesses, these businesses have had to turn to nontraditional sources of financing such as venture capitalists and pension funds. Typically, these sources of financing want either an equity stake in the business or, at a minimum, debt that can be converted into equity interests. A small business operating as a partnership or C corporation may offer these benefits to a financier and thereby use these sources of capital. An S corporation, however, may not offer a similar set of inducements to financiers. Restrictions in subchapter S limit or outright preclude tapping these sources of financing.

The S corporation reform legislation would not alter the essence of S corporation taxation; rather, it merely would remove many of the obstacles that entrepreneurs who own S corporations long have identified as major hindrances to their growth. S. 758, if enacted, would amend the tax Code to address the pace of modern business, without compromising the framework of our federal tax system.

The proposed modernization of subchapter S is necessary for the continued success of the 1.9 million existing S corporations. Newly-formed entities now are able to chose a form of business, such as a limited liability company, that provides far more beneficial treatment than that currently afforded to an existing S corporation. Yet, the current tax laws render it impractical, from a business perspective, for an existing S corporation to liquidate and then reform as a limited liability company. Under current tax laws, liquidation of an existing S corporation results in a taxable event. Due to this toll charge, exiting corporate solution is not practical for many, if not most, existing S corporations. In modernizing subchapter S to address the real business concerns faced today by S corporations, S. 758 would help level the playing field for existing S corporations.

The S Corporation Act of 1995 contains over twenty-five separate proposals, most of which were included in S. 1690, the S Corporation Reform Act of 1993, which was supported by more than one-third of the Senate in the 103rd Congress. The AICPA fully supports the essence of the legislation and the general goal of modernizing subchapter S.

We still, however, are developing our position on a number of the provisions of S. 758. Thus, we offer now our position on most, but not all, of the more significant provisions included in the 1995 Senate bill. Once we adopt an official position on the remaining provisions, however, we would welcome an opportunity to share our views with the Subcommittee.

As noted above, the S corporation reform package, taken as a whole, would modernize the Code by accomplishing four broad goals:

- Expansion of the capital formation techniques available to S corporations;
- Preservation of family-owned businesses;
- Reform of S corporation fringe benefit rules; and

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*porations and Home Office Deductions, Prepared for May 26 Senate Finance Subcommittee on Taxation and IRS Oversight Hearing, Issued May 24, 1995,* at page 16.

[2] See id. at page 14 (text) and page 20 (Chart 1.—S Corporations as Fraction of All Corporations).

- Removal of undesirable tax traps.

EXPANSION OF CAPITAL FORMATION TECHNIQUES

*Permit an S corporation to own more than 80 percent of a C corporation's stock and to own S corporation stock. [S. 758, section 221.]*

Under current law, an S corporation may own as much as 79 percent of the stock of a C corporation without jeopardizing the S election. Yet, for valid, nontax business reasons, corporations frequently establish subsidiaries to hold their different business activities. Normally, these would be wholly-owned subsidiaries. An S corporation is precluded from using this ownership structure because of the prohibition on affiliated companies. Currently, this business goal may only be accomplished by using inefficient and costly tax planning techniques.

In addition, current law does not permit an S corporation to have corporate shareholders. Thus, an S corporation may not own the stock of another S corporation.

Example: A local general construction company, organized as an S corporation, has developed expertise in asbestos abatement and removal. Concerns about potential liability exposure, however, may cause the corporation to withdraw from this business, unless it can be dropped into a separate subsidiary. Under current law, this generally may not be accomplished. In addition, the current restrictions on corporate shareholders of an S corporation create the need for an unnecessarily inefficient and costly corporate structure the owners of the construction company could form a new "sister" corporation to engage in the asbestos removal business to achieve passthrough treatment of an asbestos subsidiary, which might be favored for valid business reasons.

We recommend (1) that a corporation be permitted to elect S status regardless of the percentage of stock it owns in a C corporation subsidiary and (2) that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. S. 758, generally, would accomplish this goal and we support the legislative effort to achieve this objective. It appears, however, that the bill would mandate passthrough treatment for a wholly-owned corporate subsidiary. As a result, this approach would distinguish between a 100-percent-owned corporate subsidiary (that is, one which would be treated as a "qualified subchapter S subsidiary") and a 99-percent-owned corporate subsidiary (that is, one which would be treated as a C corporation). We plan to further examine the details of the provision and, as appropriate, to offer suggested language for inclusion in committee reports or other legislative explanations of the bill.

*Permit S corporations to issue preferred stock. [S. 758, section 201.]*

Under current law, an S corporation is permitted to have only one class of stock. This presents a serious problem for S corporations seeking venture capital, because venture capitalists and other outside sources of funding generally require an equity position that provides a preferred return with the upside potential for capital gain to enhance the rate of return on investment.

Example: A small S corporation has developed a promising new product. To bring it to market, it requires outside investment capital. With family and commercial bank sources of capital exhausted, it now seeks venture capital. As an S corporation, it is precluded from offering venture capitalists an economically attractive investment opportunity.

We recommend that S corporations be permitted to issue preferred stock, including convertible preferred stock. S. 758 would enable S corporations to issue "plain vanilla" (that is, nonvoting and nonconvertible) preferred stock. We continue to urge that the proposal be expanded to permit an S corporation to issue convertible preferred stock. Further, the bill would treat any distributions paid on such stock as interest for federal tax purposes and, thus, no operating income or loss of the entity would be allocated to the preferred stock. We find this treatment of distributions to be an implicit consequence of treating the preferred stock as debt and do not consider the approach to be inconsistent with our recommendation.

*Expand "safe harbor straight debt" to permit convertible debt. [S. 758, section 202.]*

Under current law, it is possible that debt may be recharacterized as a second class of stock. However, an obligation that qualifies as "straight debt" is not considered a second class of stock and, thus, does not trigger a termination of the S election. For example, if the debt contains conversion and liquidation rights, which "straight debt" is not permitted to contain, the entity's S election could be in jeopardy.

The problem this presents is that, in today's business world, debt instruments frequently contain convertibility features. Under current law, S corporations are at risk that this convertible debt could be construed as a "second class of stock," which

would terminate S status. This common debt feature should not terminate S status. While current regulations offer some flexibility, these rules do not adequately resolve this problem.

We recommend, therefore, that the "straight debt" safe harbor provisions be expanded to allow the issuance of convertible debt. S. 758 would clarify that "straight debt" may include a convertibility feature. In our opinion, this provision is comparable to implicitly treating a convertible debenture as convertible preferred stock and, thus, we reiterate our recommendation stated above that the bill be expanded to explicitly permit an S corporation to issue convertible preferred stock.

*Expand "safe harbor straight debt" to permit ineligible shareholders to hold the debt. [S. 758, section 202.]*

Under current tax law, "straight debt" may only be owned by an individual, an estate, or a trust that is eligible to be an S corporation shareholder. This presents a problem because loans from financial institutions and other arm's-length borrowing would not be treated as safe harbored "straight debt."

To expand financing opportunities for S corporations, we recommend the definition of "straight debt" be expanded so that loans from financial institutions and other lenders not be subjected to greater restrictions than loans made by others. S. 758 would expand the safe harbored "straight debt" treatment to include debt held by any person actively engaged in the trade or business of lending money.

*Permit certain tax-exempt organizations to be eligible shareholders. [S. 758, section 111.]*

Under current law, a tax-exempt organization is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem because tax-exempt organizations, including pension plans, ESOPs (a qualified employee stock ownership plan), and university endowment funds, are significant sources of capital for small closely-held businesses seeking to expand their operations. Since tax-exempt organizations are ineligible shareholders, these sources of capital are unavailable to S corporations, again placing them at a competitive disadvantages as compared to C corporations.

> Example: The founder of an S corporation wants to retire and would like to sell the business to the employees. To obtain the financing required for an employee purchase, a C corporation normally would establish an ESOP. This S corporation owner, however, will likely be forced to sell to outside interests and not to the employees because an ESOP is an ineligible shareholder.

We recommend tax-exempt organizations be eligible to hold stock in S corporations. This proposal would allow the partnership flow-through approach to be used with exempt organization shareholders of an S corporation. Under this recommendation, any trade or business income allocable to the exempt organization shareholder would be subject to the unrelated business income tax (UBIT), but interest and dividend income would not. S. 758 would permit charitable organizations, qualified retirement plans, and ESOPs to hold S corporation stock. In addition, the bill would subject any trade or business income allocable to the exempt organization shareholder, but presumably not interest and dividend income, to UBIT.

*Allow nonresident alien shareholders to own S corporation stock. [S. 758, section 113.]*

Under current law, a nonresident alien is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem for S corporations because, frequently, sources of capital or entre to foreign markets require an equity participation by a nonresident alien.

> Example: A local S corporation manufacturer has an opportunity to expand sales into the European market. A European individual who will manage overseas marketing wants to invest in a minority equity position in the company. The restriction on ownership of S corporation stock by nonresident alien shareholders forces the manufacturer to either give up its S corporation status or resort to unnecessarily sophisticated and expensive tax planning techniques.

We recommend that nonresident aliens (individuals only) be treated as eligible shareholders. Under this recommendation, any effectively connected U.S. income allocable to the nonresident alien should be subject to a withholding tax similar to the tax imposed on nonresident partners of a partnership. S. 758 would permit individual nonresident alien shareholders, while subjecting such shareholders to the U.S. withholding taxes applied to nonresident alien partners in U.S. partnerships. In addition, S. 758 would treat the nonresident alien shareholder as having a U.S. permanent establishment if the S corporation has a permanent establishment in the U.S. This "permanent-establishment" aspect of the proposal exceeds the scope of our recommendation and we do not yet have an official position on it.

PRESERVE FAMILY-OWNED BUSINESSES

*Increase the thirty-five-shareholder limitation to fifty shareholders. [S. 758, section 101.]*

Under current law, an S corporation election is not valid if the business has more than 35 shareholders. This presents a problem for multi-generational, family-held businesses. This highly artificial limit on the number of shareholders prevents a corporation from continuing to operate as an S corporation as the number of shareholding generations increases. Also, some high-tech corporations that want to reward key employees are artificially limited to a thirty-five-shareholder limitation.

Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to continue into the next generation.

We recommend the current S corporation limit of 35 shareholders, which creates preservation problems and also serves to restrict capital formation opportunities of smaller businesses, be raised to 50 shareholders. S. 758 would expand the number of permitted shareholders to 50 and, taking this proposal in conjunction with the special attribution rule discussed below, would help lessen the problems encountered by an S corporation with two or more founding families.

*Count all members of a single family who own an S corporation's stock as a single shareholder. [S. 758, section 102.]*

Under current law, only a husband and wife are treated as one shareholder for purposes of the S corporation election. All other members of a family are treated as separate shareholders. For multi-generational, family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations.

We recommend that, in determining if the current 35-shareholder (or the proposed 50-shareholder) limitation is exceeded, all family members be treated as one S corporation shareholder. For all other purposes, however, all actual shareholders would be treated as shareholders. S. 758, generally, would allow an S corporation to elect to treat the members of one family owning its stock as a single shareholder in applying the shareholder limitation.

*Expand trusts permitted to own S corporation stock to include those with multiple income beneficiaries, the ability to accumulate trust income, and trustee powers to spray income among the beneficiaries. [S. 758, section 114.]*

Under current law, only certain types of trusts are permitted to be shareholders of an S corporation. The two most common types of eligible trust shareholders include the grantor trust and the "qualified subchapter S trust" (QSST). The problem this presents for S corporation owners is that many common trusts used for estate planning purposes have multiple beneficiaries and sprinkling powers vested in the trustee. These trusts are not allowed to hold S corporation stock. As a result, S corporation shareholders do not have access to the same estate planning techniques available to C corporation owners.

Example: An S corporation owner has an ailing spouse and several children. To properly provide for the family at the owner's death, the owner will probably want to use a trust that allows the trustee to make distributions to care for the medical needs of the ailing spouse and the varying educational needs of the children. To accomplish this, the owner will need to terminate S corporation status or resort to unnecessarily complicated and expensive estate planning techniques.

We recommend that trusts having multiple-income beneficiaries, the ability to accumulate trust income, and trustee powers to spray income among beneficiaries be treated as eligible S corporation shareholders. S. 758 would introduce a new type of trust, an electing small business trust, which would be permitted to own S corporation stock, as well as have multiple-income beneficiaries, the ability to accumulate trust income, and trustee powers to spray income among beneficiaries. Multiple beneficiaries would each be counted as S corporation shareholders. We did not recommend the concept of an electing small business trust as the means of achieving our suggested result and, thus, are not in a position at this time to comment on the specifics, including the proposed tax treatment, of such a trust.

REFORM S CORPORATION FRINGE BENEFIT TREATMENT

*Place S corporation shareholders in the same position as owners of C corporations with respect to fringe benefits. [S. 758, section 227.]*

Under current law, an S corporation, unlike a C corporation, is not permitted to provide shareholders-employees with certain tax-favored fringe benefits. Instead, for fringe benefits purposes, the S corporation is treated as a partnership and 2-percent shareholders are treated as partners. All other shareholders-employees of the S corporation are treated like employees of a C corporation with respect to fringe benefits.

The problem here is that S corporations operate at a substantial disadvantage as compared to C corporations with respect to fringe benefits paid to an owner-employee. For owners of small businesses this is especially onerous because their fringe benefits are a greater portion of their overall compensation. Furthermore, owners of S corporations (like owners of partnerships and C corporations) already are governed by extensive antidiscrimination rules that make the Code section 1372 treatment described above unnecessary.

Example: All the employees of a small retail store (including the owners) receive medical and group-term life insurance coverage. As a C corporation, these benefits are tax-free to all employees including the owners. If this corporation elects S status, however, the benefits will be taxable to the owners.

To solve this problem, we recommend the repeal of section 1372 of the Code. S. 758 would, through the repeal of that section of the Code, put S corporation shareholders-employees in the same position as are shareholders-employees of C corporations with respect to most fringe benefits. The bill, as we read it, also would amend section 162 of the Code to provide specifically that the deduction for health insurance costs of self-employed individuals would be available to 2-percent shareholders of an S corporation. It is our understanding, however, that the legislative intent is that the amendment to Code section 162 would result in the partnership rules continuing to apply for the health insurance costs of 2-percent shareholders of an S corporation. While we still support across-the-board application of the C corporation rules for S-corporation fringe benefits purposes, we are pleased that S. 758 addresses at least part of our concerns. We believe, however, that a technical fix might be required to achieve the intended result as to the treatment of health insurance costs of 2-percent shareholders of an S corporation.

*Repeal restrictions on qualified plan loans made to S corporation shareholders. [S. 758, section 301.]*

Under current law, a loan by a corporation's qualified retirement plan to a "disqualified person" is a prohibited transaction, subjecting the borrower to a penalty tax. For C corporations, a disqualified person includes any shareholder who owns ten percent or more of the corporation's stock. For an S corporation, however, any shareholder who owns five percent or more of the corporation's stock is a disqualified person.

The problem here is that, at the time a C corporation makes an S election, any shareholder who owns between five and ten percent of the qualified retirement plan's corporate sponsor corporation must repay the loan before the effective date of the S election or face an automatic penalty tax. As a practical matter, very few people are aware that the restrictions on loans from qualified retirement plans are more stringent for an S corporation than for a C corporation. Consequently, five-to-ten-percent shareholders of a C corporation that elects S status may inadvertently find themselves subject to a penalty tax for failing to repay loans from qualified plans before the effective date of the S election.

Example: A small software development company operates as a C corporation and maintains a qualified pension plan for its employees. An employee, who also owns 6 percent of the corporation's stock, borrows $10,000 from the plan to pay for a family medical emergency. The corporation elects to be an S corporation. The borrower-shareholder is unaware of the more restrictive limitation on plan loans to S corporation shareholders-employees and fails to fully repay the loan before the S election takes effect. The borrower-shareholder becomes subject to the automatic penalty tax.

We view this as a trap for the unwary and recommend that the current, more restrictive limitation on S corporation shareholders be repealed. In our opinion, the definition of a "disqualified person," as including a ten-percent-or-greater shareholder, should apply uniformly to both C corporations and S corporations. S. 758 would end this different treatment by eliminating the more restrictive rule that currently applies to S corporation shareholders and permitting the current C corporation rule to apply also to plans sponsored by S corporations.

REMOVE UNDESIRABLE TAX TRAPS

*Expand the period of post-death S qualification for certain trusts. [S. 758, section 121.]*

Under current law, a testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of a deceased S corporation shareholder. There is also a similar two-year rule for grantor trusts and deemed grantor trusts. After the 60-day period, the trust must transfer ownership of the shares to an eligible S corporation shareholder or (if qualified) become a QSST. The 60-day period is extended to two years if the entire corpus of the trust is included in the grantor's estate.

The requirement that the trust transfer ownership of its S corporation shares within the 60-day period is a significant compliance and administrative burden for many taxpayers. The trustee may be unaware of the need to transfer the S corporation stock until advised to do so by a tax advisor who is involved in the administration of the decedent's estate. Often, this may not occur until more than 60 days following the decedent's death.

> Example: The owner of a 20-percent interest in the stock of an S corporation that operates a farm equipment dealership provided in her will that on her death her stock would pass to a testamentary trust. A family member was named the trustee. The shareholder died on April 15, 1994. Not until August, 1994, at which time the estate's executor began to focus on the detailed information for the estate tax return, did the trustee discover that the S corporation stock should have been transferred out of the trust within 60 days after the shareholder's death. As a result, the corporation's S election terminated on the sixty-first day.

We recommend that the period of time that the trust may own the S corporation stock be extended to two years (the same period as permitted for grantor trusts). Enactment of a two-year period would help relieve compliance and inadvertent termination problems. S. 758 would provide for a two-year period.

*Permit the Secretary of Treasury to treat invalid elections as effective. [S. 758, section 211.]*

Under current law, the Internal Revenue Service (the IRS) has the authority to waive the effect of an inadvertent S corporation termination, but not the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as an S corporation.

We believe the IRS should have the authority to waive an inadvertent invalid S corporation election for entities that have subsequently cured the defect. This new authority would broaden the current IRS authority to waive the effect of an inadvertent S corporation termination. S. 758 would expand this authority and permit the IRS to validate an otherwise invalid S election. In addition, S. 758 would give the IRS the authority to treat a late S election as timely filed if there was reasonable cause for the late filing. We also support this additional provision.

*Provide for automatic waiver of certain inadvertent terminations. [S. 758, section 211.]*

Under current law, the IRS has the authority to waive the effect of an inadvertent S corporation termination and *may* have authority to automatically waive such effect. A high percentage of private letter ruling requests on S corporations deal with the issue of inadvertent terminations. For many taxpayers, obtaining a waiver of their terminated S status involves costly professional fees. Also, valuable time on the part of IRS personnel and tax professionals is lost on processing routine taxpayer waiver requests.

We recommend an automatic waiver procedure be authorized by Congress so that an entity would not lose its S corporation status due to a terminating event of a "ministerial" nature. An example of such an event is the failure by a beneficiary to make a QSST election. S. 758 would provide for an automatic waiver procedure for certain inadvertent terminations. We further note that the IRS already exercises similar authority with respect to missed QSST elections and suggest that the IRS further expand its use of this authority.

*Repeal excessive passive investment income as a termination event. [S. 758, section 214.]*

Under current law, subchapter S contains two disincentives to discourage "incorporated pocketbooks" from operating as S corporations. First a corporate-level tax is imposed on excess passive investment income. Second, S status is terminated if the corporation earns passive investment income that exceeds 25 percent of the enti-

ty's gross receipts for three consecutive taxable years and the entity has accumulated subchapter C earnings and profits at the end of each of the three years.

While this result may be avoided through proper tax planning, many unadvised S corporations are caught unaware of these traps and lose their S status. The sanction of terminating S status because the entity has excessive passive income is unduly harsh.

Example: Due to business fluctuations, the operating business of an S corporation declines over a period of several years. During the recession, a substantial portion of the corporation's income is derived from passive sources. Without proper advice, this corporation may not realize that its S status will terminate if this situation continues for three years.

To the extent Congressional intent is to limit the passive income of an S corporation, we believe this legislative intent is sufficiently served through the current procedures of imposing a corporate-level tax on the S corporation's passive income. Therefore, we believe that the sanction of terminating the S election in the situation of excessive passive income should be repealed. S. 758 would increase the threshold for taxing excess passive income from 25 percent to 50 percent. The legislation also would provide that an S corporation would not lose its S corporation status if it has excess passive income for three consecutive years. Instead, the corporate-level tax rate applied to the excess passive income, beginning in the fourth consecutive year, would increase by 10 percentage points for each successive year up to a maximum of a 50-percentage point increase. The legislative proposal differs from our recommendation and, thus, we are not yet in a position to offer an official position on this provision of S. 758.

*Exclude trade or business income from the passive investment income definition. [S. 758 includes no such provision.]*

Under current law, the definition of passive investment income for S corporation purposes includes the types of income earned by a personal holding company and many traditional types of active trade or business income earned by an operating company. The inclusion of certain types of active trade or business income in the passive investment income definition precludes many operating companies from making the S election. I22Examples: Examples of such operating companies include certain rental real estate operators and certain corporations earning royalty income from the franchising of a product, process, or service.

We recommend the income earned from the active conduct of a trade or business not be included in the S corporation definition of passive income. Instead, a facts-and-circumstances test should be adopted to determine what constitutes active as opposed to passive income. Although S. 758 would not exclude trade or business income from the subchapter S definition of passive income, we continue to urge the inclusion of a statutory active-trade-or-business exception, much like the exception currently provided in the Treasury regulations under section 1362 of the Code.

Once again, we appreciate the opportunity to present our views for inclusion in the hearing record. We would be pleased to answer any questions or submit additional information upon the request of any member of the Subcommittee.

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PREPARED STATEMENT OF CRAIG WILLETT

Mr. Chairman, I would like to thank this committee and my own senator, Senator Orrin Hatch, for the invitation to appear before you today. I am submitting this testimony on behalf of the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization, representing over 600,000 small business owners from all fifty states. My name is Craig Willett, and I am a small business owner and CPA from Provo, Utah. I have a Masters Degree in Taxation and specialize in tax compliance, tax planning, and tax strategy. I started my practice eight years ago and during that past eight years, I have also started several other small businesses. I currently employ five staff members.

My involvement as advisor to the board of several other businesses has provided me background and practical knowledge of the difficulties small businesses face in this country.

I have enjoyed the opportunity to testify before Congress in the past on small business issues, and I was also vice-chairman of the Utah delegation to the 1995 White House Conference on Small Business.

In addition to my professional involvement as a CPA, I volunteer time to different associations and organizations in helping them and their members understand and comply with tax laws, government regulation, and strategic economic decisions.

I appreciate the opportunity to participate in this hearing to examine the proposal to change the rules for claiming expenses for the business use of a home. I believe that the changes proposed in Section 353 and 354 will not only help small businesses but the entire nation.

With the change in the economy over the past five years, Corporate America has downsized. Those who become displaced as a result of corporate downsizing often contract with their former employers. These self-employed are budding small businesses and the embryo of tomorrow's employers and profitable companies. Many of these small businesses choose to operate their business out of their home and dedicate space in their home for an office. Some businesses purchase fax machines and computers to maintain their records, conduct their business and perform their billing functions. Other businesses use their home office to study, prepare documents and presentations or meet with clients. Without a centralized office, some of the business owners would have a very inefficient business setup.

Section 280A of the Internal Revenue Code requires taxpayers wishing to take the home office deduction to use a portion of their home exclusively for business purposes. In addition, the office must be (1) the principal place of business; (2) the place used by clients or customers; or (3) a separate structure on the same property as the home. The major part of the conflict between the Internal Revenue Service and taxpayers stems from the argument of what constitutes a "principal place of business."

Section 280A was enacted by Congress to establish a less subjective, uniform standard for determining which offices qualify for the home office deduction. Despite this effort, different courts in different jurisdictions began establishing their own tests to determine whether an office was qualified. The phrase "principal place of business" was the basis for most of the variations between the tests. Some courts adopted a "focal point" test, which looked at where services are provided and where the income is generated. This test proved to be too narrow and so some courts adopted a "dominant portion of the work" test to replace it. This new test would only require that the business perform a dominant portion of the business's activities from the home office.

The U.S. Tax Court rejected the focal point test and the other tests and developed its own. Under the tax court test, the court would look at the facts and circumstances of each case and determine whether or not a home office was eligible for the deduction by examining (1) if the office was essential to the business; (2) if the office was used for a substantial amount of time; and (3) if there were other locations where this work could be done. Once again this test was eliminated in 1993 as the U.S. Supreme Court created its own test in the Soliman decision.

In 1993, the Supreme Court handed down a critical decision in *Commissioner* v. *Soliman*. This case involved an anesthesiologist who had patients that he visited in the hospital but he performed all of his necessary paperwork such as billings, payables, and the storing of document records at home. The Court found that Mr. Soliman did not qualify for the home office deduction because he serviced his customers and spent the majority of his time at the hospital. The Court, through its use of the plain English definition of the work "principal," held that the hospital was Mr. Soliman's principal place of business.

In order to perform his job as an anesthesiologist, Mr. Soliman is required to study and prepare for the procedures that he needs to perform for his patients. This essential preparation takes place in his home office. In order to have a business and to keep the business running, a business owner needs to bill his patients. This necessary billing function occurs in the home office though the actual work with the patients is performed at the hospital. It seems to me that the court missed the point. This is what is causing most small business owners to be up in arms about the *Soliman* decision. Mr. Soliman may use the hospital to perform surgery and follow up with patients but how can he earn a living if he cannot perform such necessary functions as billing or studying procedures so that he can properly treat his patients. Even though these functions may not represent over 50 percent of his time, they are necessary functions. Without billings going out and payments coming in, Mr. Soliman has no incentive to perform his services. He would not have a very effective business if he did not send out bills, receive payments, or maintain patient records required by law.

Most of the confusion over the home office deduction is caused by the phrase "principal place of business." The Supreme Court read this statute literally and came to the conclusion that a taxpayer can only have one "principal" place of business and the "principal place" is determined by the importance of the activities performed at each location and how much time is spent at each location. In other words, this location must be where most of the business activity takes place. It is

possible for taxpayers to have no principal place of business if the Supreme Court tests are not met.

THE IMPACT OF SOLIMAN ON SMALL BUSINESSES

Maintaining the current law under the *Soliman* decision would be another blow by the tax system to the self-employed, in addition to such actions as the self employed health insurance deduction. I do want to commend and thank this Committee and the Senate for taking the lead to increase this deduction to a permanent 30 percent. This is still not far enough, but it is a step in the right direction.

My firm currently maintains a client base of over 800 clients. Of these clients, the majority are small or closely-held small business owners. Under *Soliman*, only 2 percent of these clients qualify for the home office deduction. Under the proposed changes in Section 353, an additional 15 to 20 percent will qualify. The following are some examples of actual clients who are currently unable to qualify for the home office deduction.

**General Contractor.** One of my clients has an office in his home in which he pays his bills, bills his clients, prepares his bids, prepares his payroll, maintains his accounting, and stores all of his plans, inspection certificates, forms, and paperwork. He has an equipment shed behind his house in which he stores all his equipment and tools. In addition to these items, he also meets with potential clients and subcontractors to review and finalize plans and renegotiate bids. These duties are performed during the evening hours as he spends eight hours a day at job sites performing services such as carpentry and framing.

Revenues come from building homes although all negotiations and contracts are signed and discussed at his home office.

This contractor took the home office deduction in 1992 and the Internal Revenue Service audited his tax return. The *Soliman* case was decided between the time the return was filed and the time the return was audited. The home office deduction was disallowed, costing the taxpayer over $2,000 in taxes.

It is unfair to have the federal government require this client to maintain payroll records, licenses, W-9 and W-4 forms but not allow him to take a deduction for the cost of storing these items and complying with the law. He has nowhere else to perform these administrative duties and does not have enough room in his truck to store all of the required information nor is it safe or secure to store such documents there.

**Management Consultant.** I have several clients who are management consultants and travel to various locations and conduct employee training seminars. These business owners produce all of their work products within their home office. They use their office as a place to create, prepare, produce and research items for their seminars. Some also use their office to create training materials, pamphlets, visual aids, and promotional material. This production is performed on computers, printers, copy machines, and video equipment. In addition to the production of their seminars, these clients must maintain a current library of up to date information relating to their profession, maintain a safe place to store their production equipment, and perform all travel arrangements, billings, and accounts payable functions.

Under the *Soliman* decision, these clients do not qualify for the home office deduction because the majority of their time is spent on site speaking and presenting their seminars. Because the main revenue source is outside of the home office, it is not considered a principal place of business.

**Interior Designer.** Another one of my clients is an interior designer who performs 80 percent of her work in other people's homes. This client, like contractors and consultants, uses a home office to perform essential business activities such as bookkeeping, accounting, and storing client records and required information for taxes and employees. Additionally, she needs a place to store product samples, supplier records, and current inventory before delivery. Although this client may spend up to 80 percent of her time out of her home office, it is essential that she have a place to keep the records such as client billings and business expenses. Like the two previous examples, this client is unable to take the deduction for her home office because she spends the majority of her time at other locations and her primary revenue source is meeting with clients outside the home office.

These three examples detail necessary functions essential to business success, billing to generate revenues, paying bills to maintain suppliers, and maintaining employee records for three years as required by law. These taxpayers need to have a place to perform these functions and should be allowed to dedicate a part of their home exclusively for these functions and be entitled to a deduction much the same as someone who chooses to rent an office.

PROPOSED SOLUTIONS

Much of the controversy over who is eligible for the home office deduction stems from the portion of Section 280A of the Internal Revenue Code that states that a home office deduction may be taken on the portion of the home that is the "principal place of business." In order to solve the current problem, this language must re-define and clarify the principal place of business. If a contractor cannot claim his home office as his principal place of business, are we to assume that he uses his truck as his office? If enacted, the changes to Section 280A would be more consistent with a determination of whether the home office is the principal office of the business as opposed to the principal place of business.

Section 353 clearly defines "principal place of business" to include a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

I would also like to mention another class of business owners who need legislative relief. These are sales representatives. Current law permits the storage of inventory that is to be resold, but it is silent on the storage of product samples. For example, a sales representative will carry the manufacturer's full line of clothes requiring extensive storage and moving.

Section 354 will permit sales representatives to qualify for home office use for the storage of product samples as well as actual inventory. The only change from the current rule for inventory would be that storing of product samples would also be permitted if the business owner satisfied all of the current requirements under the rules in existence for inventory storage.

With the proposed changes in the legislation the committee is addressing today, the clients listed above, as well as many other small business owners, will be afforded a much needed deduction for maintaining a home office. I am in support of this proposal, and I believe that this is a step toward a tax code less discriminatory against self-employed taxpayers. I am pleased that the Senate Finance Committee is willing to listen to my concerns and is willing to further clarify this proposal.

Thank you, Mr. Chairman and members of the committee.

## COMMUNICATIONS

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### STATEMENT OF THE AMERICAN BAR ASSOCIATION

(SUBMITTED BY N. JEROLD COHEN)

#### INTRODUCTION

The following comments are the views of the Section of Taxation of the American Bar Association and do not represent the position of the American Bar Association or its House of Delegates or Board of Governors. Although many of the members of the Section who participated in the preparation of these comments necessarily have clients affected by federal taxation, including the federal tax rules applied in the subject area addressed by these comments, no such member (or the firm of such member) has been engaged by a client with respect to the specific subject matter of these comments.

The Section of Taxation ("Section") supports the enactment of the amendments to the Internal Revenue Code of 1986 (the "Code") set forth in H.R. 2039, the S Corporation Reform Act of 1995 (the "Bill"). The Bill would broaden the eligibility rules and enhance the attractiveness of S corporations to small businesses, simplify the complex rules for S corporations and their shareholders, promote fairness to taxpayers by mitigating certain traps for the unwary under the current provisions of Subchapter S, and generally enhance the utility of the corporate form of doing business. The Bill further expands the capital raising techniques available to S corporations and provides for the preservation of family businesses through a liberal family shareholder aggregation rule and more flexible trust arrangements.

The following comments are designed to point out certain policy issues and technical aspects of the current draft of the Bill.

*Section 101—S Corporations Permitted to Have 75 Shareholders.*

A. *Overview.* Bill section 101 would amend Code section 1361(b)(1) to increase the number of permitted shareholders from 35 to 75. No rationale is furnished for selection of the number of 75. Along with the special election to consider the members of one family as one shareholder (Bill section 102), this provision expands the availability of S status, particularly to family controlled corporations in which the stock is held by several generations of related shareholders.

B. *Comments.* The provision should be helpful to many successful corporations that are at or near the 35 shareholder limit as a result of their longevity and the distribution of stock to lower generations of family shareholders.

The Section supports the increase in the numerical shareholder limitation, and the family aggregation rule of Bill section 102, in order to make it easier for S corporations to preserve the ownership of family business over several generations.

*Section 102—Members of Family Treated as One Shareholder.*

A. *Overview.* Solely for purposes of counting the number of S corporation shareholders to determine if the 75 shareholder test is satisfied, Bill section 102 amends Code section 1361(c) to provide that in the case of shareholders of an S corporation who are members of the same family, all members of the family shall be treated as one shareholder, provided a special election is made with the consent of all shareholders. Only one family in a corporation may be treated as one shareholder under the aggregation rule. The members of the family include the lineal descendants of a common ancestor, up to six generations removed from the common ancestor.

B. *Comments.* The Section supports the family aggregation rule of Bill section 102, making it easier for S corporations to preserve the ownership of family businesses over several generations.

However, under the language of the proposed family aggregation rule, it is questionable whether the common ancestor is a member of the family, although the

spouse of the common ancestor is a member of the family. Although the point is minor, it is recommended that the language be drafted to clearly include the common ancestor as follows:

"(B) Members of the Family.—For purposes of subparagraph (A)(ii), the term 'members of the family' means the common ancestor, the lineal descendants of the common ancestor and the spouses (or former spouses) of such lineal descendants or common ancestor."

*Section 111—Certain Exempt Organizations Allowed to be Shareholders of an S Corporation.*

A. *Overview.* Section 111 of the Bill would amend Code section 1361(b)(1)(B) to allow: (i) a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit-sharing plan (including an ESOP), or (ii) a section 501(c)(3) organization to be a permitted S corporation shareholder. Tax-exempt shareholders would be subject to the unrelated business income tax on the pro rata share of the S corporation's income or loss from a trade or business regularly carried on by the S corporation. Code section 170(e)(1), relating to certain contributions of ordinary income and capital gains property, would be amended to provide that in connection with a contribution of S corporation stock to a charitable organization, a special "hot assets" rule similar to the rule of Code section 751 would apply in determining the portion of gain that would not have been long-term capital gain if the S corporation stock had been sold at its fair market value.

B. *Comments.* The Section supports the amendment to the Code allowing a qualified retirement trust under Code section 401(a) or a tax-exempt organization described in Code section 501(c)(3) to be an eligible shareholder of an S corporation. This provision will enable an S corporation to issue stock to an ESOP and permit S corporation shareholders to make gifts of shares of S stock to tax-exempt charities. An exempt organization's pro rata share of the S corporation income or loss from a trade or business regularly carried on by the S corporation will be subject to tax under the unrelated business income tax. For charitable contribution purposes, rules similar to the hot assets rule contained in Code section 751 will determine the extent to which a gift of stock will be treated as a contribution of capital gain property.

*Section 112—Only Financial Institutions Which Use the Reserve Method of Accounting for Bad Debts Would be Classified as Ineligible Corporations.*

A. *Overview.* Section 112 of the Bill would amend Code section 1361(b)(2) to provide that a financial institution that does not use the reserve method of accounting for bad debts described in Code sections 585 (the experience method) or 593 (the percentage of taxable income method) would be eligible to make an S election, provided it met the other requirements for the election.

B. *Comments.* Under present law, a financial institution is ineligible for S corporation status if (i) Code section 585 applies to the institution (or would apply but for the large bank exclusion in Code section 585(c) or (ii) Code section 593 applies to the institution. A financial institution is therefore precluded from electing S status whether or not the institution uses the reserve for bad debts method provided in Code sections 585 or 593. This provision was enacted in conjunction with the Subchapter S Revision Act of 1982 ("SSRA"). Prior to 1982, the limits on passive investment income effectively precluded the use of S corporation status by most financial institutions. Code section 1361(b)(2)(B) was enacted to restrict the availability of bad debt deductions based on reserves for bad debts under Code sections 585 and 593, since the allowance of such deductions to an S corporation could have made these deductions available to individuals.

Neither Code section 585 nor 593 is mandatory with respect to financial institutions. The proposed amendment carries out the original intent of Congress to limit the availability of the reserve method of accounting for bad debts described in Code section 585 or 593. Under the proposed provision, corporations that actually use the reserve method of accounting for bad debts continue to be ineligible for S corporation status. However, financial institutions that do not elect the use of the reserve method of accounting for bad debts will be eligible for S corporation status under the Bill.

*Section 113—Nonresident Aliens Allowed to be Shareholders of an S Corporation.*

A. *Overview.* Section 113 of the Bill would amend Code section 1361(b) to permit nonresident alien individuals to be S corporation shareholders. Code section 1446 would be amended to require the S corporation to withhold tax on effectively connected income allocable to nonresident alien shareholders, in a manner similar to partnerships with nonresident partners.

B. *Comments.* The Section supports the amendment to the Code allowing nonresident aliens to be S corporation shareholders. The United States has entered into income tax treaties with many foreign countries that contain clauses prohibiting the tax laws from discriminating in certain ways against foreign persons, and it has been suggested that treaty nondiscrimination provisions should allow certain nonresident aliens to own the stock of an S corporation. See, e.g., Article 24(5) of the U.S. treaty with the United Kingdom. The application of the partnership withholding rules should ensure that tax avoidance does not result from the ownership of interests in a pass-thru entity by an individual outside of the jurisdiction of the Internal Revenue Service (the "Service").

Code section 1446(d) is proposed to be amended to provide that any withheld amount is treated as distributed to the foreign shareholder by the S corporation on the earlier of (i) the date the withholding tax is paid by the S corporation, or (ii) the last day of the S corporation's taxable year for which the tax is paid. It should be noted that this provision could potentially create a trap for the unwary under the one class of stock rules. The Regulations address this issue only in the context of state law requirements for payment and withholding of income tax. See, e.g., Regulations § 1.1361-1(l)(2)(ii). By analogy, as long as the remaining shareholders have the right to distributions that take the withholding tax distributions to the nonresident alien shareholders into account, the withholding provisions of Code section 1446 should not be deemed to create non-identical rights to distributions and thus violate the one class of stock rule.

*Section 114—Electing Small Business Trusts Allowed to be Shareholders of an S Corporation.*

A. *Overview.* Section 114 of the Bill would amend the Code to permit a trust to elect to be taxed as an "electing small business trust" qualifying as a permitted shareholder of one or more S corporations, provided that (i) all beneficiaries of the trust are individuals, estates, qualified retirement trusts, or charitable organizations, (ii) no interest in the trust is acquired by purchase (that is, all interests must be acquired by gift, bequest, or inheritance), and (iii) an election is made by the trustee in the manner, form and time as prescribed in regulations. For purposes of the numerical shareholder limit, each potential current beneficiary of the trust is counted as a shareholder (or if there are no potential current beneficiaries, the trust is treated as the shareholder).

The portion of the trust that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing tax on the income attributable to the S corporation stock. The income attributable to the S corporation stock is taxed to the trust at the highest individual tax rate, subject to the special rate applicable to net capital gain. The items taken into account in computing trust income for this purpose include pass-thru items of income, loss or deduction allocable to the trust as a shareholder of S corporation stock, the gain or loss from the sale or exchange of S corporation stock, and deductions for any state or local income taxes and the administrative expenses of the trust properly allocable to the S corporation stock. In computing the trust's income tax attributable to ownership of the S corporation stock, no deduction is allowed for distributions to beneficiaries and no deduction or credit is allowed for any item other than the items described above. Furthermore, no item of income, loss, deduction or credit relating to the S corporation stock is included in the distributable net income ("DNI") of the non-S corporation portion of the trust or apportioned to any beneficiary. Finally, on the termination of all or any portion of an electing small business trust, the carryovers or excess deductions referred to in Code section 642(h), if any, shall be taken into account by the entire trust.

The non-S corporation portion of the trust is taxed under the usual rules of subchapter J. As noted above, the DNI of the non-S corporation portion of the trust does not include any income of the trust attributable to the S corporation stock, for purposes of distributions from the trust under the framework of subchapter J, or otherwise.

B. *Comments.* Under present law, a trust is a permitted shareholder of an S corporation if the trust is (i) a grantor trust, treated as being owned by an individual who is a citizen or resident of the United States under Code sections 671-677, (ii) a trust that was a grantor trust upon the death of the deemed owner, but only for a 60 day period following the deemed owner's death (unless the entire grantor trust is includable in the deemed owner's estate, in which case a two-year period applies), (iii) a testamentary trust, but only for a 60-day period following the date the stock is transferred from the estate to the trust, (iv) a voting trust, created primarily for the exercise of the voting power of stock transferred to it, (v) a qualified subchapter S trust as defined in Code section 1361(d)(3) ("QSST"), or (vi) a trust treated as

owned by an individual who is a citizen or a resident of the United States under Code section 678 (a "Section 678 trust").

In addition to the types of trusts permitted to own S corporation shares under present law, typical estate plans utilize what is known as "spray trusts," "sprinkle trusts," or "discretionary trusts," which permit the trustee to distribute income between two or more income beneficiaries. Because the needs of individual beneficiaries may change over time, spray trusts provide the trustee with the ability to meet changing needs of beneficiaries, allow the trustee to accumulate the income of the trust, and can be used to advance non-tax objectives of the testator. Unfortunately, since such trusts do not constitute one of the six types of trusts permitted to own S corporation shares (except for limited time periods after the shareholder's death), spray trusts are not normally qualified shareholders of S corporations. Accordingly, the transfer of S corporation shares to a spray trust under a typical estate plan will result in the termination of the S election. In order to avoid such a termination, complex and costly drafting is required for the estate planning documents of the S corporation shareholder in order to create separate, pocket trusts, or to eliminate the flexibility of the spray or sprinkle powers.

The electing small business trust provision is intended to address the current inability in the S corporation context to achieve legitimate estate planning goals through spray trusts. While the Section applauds any effort to make it possible to permit spray trusts to be shareholders, it is believed that the electing small business trust provision may not constitute the optimal solution to the problem. As illustrated by the following example, administration of the proposed provision by the trust and the tracing of non-taxable distributions under the subchapter J regime would be extremely complex.

C. *Illustration of Operation of Electing Small Business Trust With Income From S Corporations and Dividends, Taxable Interest, Tax-Exempt Interest and Capital Gains From Other Investments.* The operation of the electing small business trust provision by a trust with income from non-S corporation sources may be illustrated by the following example:

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Net Income from S Corporations | $ 50,000 | $ 60,000 | $ 50,000 |
| State Income Tax (6%) | (3,000) | (3,600) | (3,000) |
| Dividends Distributed from S Corporations | 25,000 | 30,000 | 15,000 |
| Other Taxable Dividends (Non-S Corporations) | 50,000 | 40,000 | 45,000 |
| Taxable Interest | 10,000 | 10,000 | 10,000 |
| Tax-Exempt Interest | 5,000 | 5,000 | 5,000 |
| Capital Gains Allocable to Trust | 10,000 | 0 | 0 |
| Administrative Expenses | (2,000) | (2,000) | (2,000) |

Tax Consequences of Distributions to Beneficiaries

Column A: Distribution to Beneficiaries
Column B: Share of Income Distribution Deduction
Column C: Share of Accumulation Distribution

| | Year 1 | | | Year 2 | | | Year 3 | | |
|---|---|---|---|---|---|---|---|---|---|
| | A | B | C | A | B | C | A | B | C |
| Beneficiary V (15% Marginal Rate) | 10,000 | 9,230 | 0 | 10,000 | 8,030 | 382 | 12,000 | 10 633 | 0 |
| Beneficiary W (28% Marginal Rate) | 20,000 | 18,462 | 0 | 10,000 | 8,030 | 382 | 12,000 | 10,633 | 0 |
| Beneficiary X (36% Marginal Rate) | 5 000 | 4,615 | 0 | 10,000 | 8,030 | 382 | 12 000 | 10,633 | 0 |
| Beneficiary Y (31% Marginal Rate) | 10,000 | 9 230 | 0 | 10,000 | 8 030 | 382 | 12,000 | 10,633 | 0 |
| Beneficiary Z (31% Marginal Rate) | 15 000 | 13,847 | 0 | 20,000 | 16,062 | 766 | 12,000 | 10 635 | 0 |
| | 60,000 | 55 384 | 0 | 60,000 | 48 182 | 2,294 | 60,000 | 53,167 | 0 |

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Trust level tax in S corporation income (39.6%) | 18,612 | 22,334.40 | 18,612 |
| Aggregate beneficiary level tax on share of income and accumulation distribution | 15,369 | 14,606 | 14,993 |
| Trust level tax on taxable income of trust (non-S corporation items, including capital gains allocable to trust) after income distribution deduction | 3,352 | 0 | 0 |
| Credit allocable to beneficiaries for tax paid by trust on undistributed net income in prior year | 0 | (706) | 0 |
| Aggregate tax liabilities of trust and beneficiaries | 37,333 | 36,234.40 | 33,605 |

The foregoing example illustrates the interplay of operations of Subchapter J on the non-S portion of the trust and the separate S portion of the trust. Present Code sections 665 through 668 provide for the treatment of accumulation distributions of a complex trust. In general, the "throw back rule" determines the tax attributable to an accumulation distribution (which occurs in year 2 of the above illustration) to a beneficiary by averaging the distribution over a number of years equal to the number of years over which the income was accumulated by the trust. The average amount is added to the beneficiary's taxable income for those years. The tax so computed may be offset by a credit for any taxes previously paid the trust with respect to this income, and any remaining tax liability is then due and payable in the same year as the tax on the beneficiary's other income for the year of the distribution. The throw back rule does not apply to any distributions of income accumulated for a beneficiary while the beneficiary is a minor (before the birth of such beneficiary or the beneficiary is 21 years of age).

In the above example, the non-S portion of the trust accumulates income in year 1. Similarly, the S portion of the trust accumulates income in year 1. In year 2, the aggregate distribution to beneficiaries of $60,000 exceeds the distributable net income of the non-S portion of the trust. Although the distributions in year 2 are attributable in part to S corporation income taxed at the trust level, the throw back rule results in an accumulation distribution accompanied by complex tax calculations. This is the result although the aggregate distributions to beneficiaries of $60,000 in year 2 were made possible by an increase in the dividends received by the trust from the S corporation, taxed at the top rate of 39.6% at the trust level.

While it is presumed that regulations would be promulgated to provide for the tax-free distribution of the electing small business trust portion of the aggregated distribution of $60,000 to beneficiaries in year 2, any method of tracking the income would necessarily be complex. Accordingly, it is unlikely that many trusts would elect to be taxed under the new provisions and subject the trustee to complex tax recordkeeping requirements. Rather, S corporation shareholders will likely continue to design their estate plans to provide for separate trusts qualifying as grantor trusts or QSSTs as under present law, or distribute shares directly to beneficiaries.

The Section believes that spray trusts, subject to the normal rules of Subchapter J, should be permitted to hold S corporation stock. The Section does not believe that a spray trust's ownership of S corporation stock would present difficult tax policy or tax administration problems. Other pass-thru entities, including partnerships, limited liability companies classified as partnerships for income tax purposes, and REITs, may be held by spray trusts under existing law. In light of the compression of the individual tax rates, the limitations on the use of multiple trusts, and the "kiddie tax" provisions (subjecting the income of children under age 14 to tax at the highest marginal rate of the parents), there is little opportunity for tax avoidance or tax minimization by trusts through allocations of income among beneficiaries. Further, because a trust must pay tax under current law at the rate of 36 percent on income in excess of $5,500 and at the rate of 39.6 percent on income in excess of $7,500, there should be no concern that the accumulation of income by a complex trust will result in a loss of tax revenue. Given the income tax limitations on trusts under Subchapter J and the compression of income tax rates, any concerns that income would be distributed only to persons who have large losses to offset the income, that income would be distributed to unrelated persons, or that distributions would be made from year to year in order to minimize income taxes, are not well founded.

The Section does not oppose the electing small business trust provisions providing that the income attributable to S corporation stock be treated as held in a separate trust, outside of the Subchapter J regime. However, it is believed that these provisions create an unnecessary complication, inconsistent with the overall goal of tax simplification. Eliminating Subchapter J for the part of a trust holding S corporation shares will lead to a whole new set of rules. The complexity of the measure, anticipation of the need for regulations to provide guidance for the tracing of the separately taxed income (similar to the accumulated adjustments account (AAA) rules in place for S corporations) and the time required by taxpayers for compliance should be considered.

*Section 121—Expansion of Post-Death Qualification Period for Certain Trusts.*

A. *Overview.* Section 121 of the Bill amends Code section 1361(c)(2) relating to certain trusts as shareholders to extend from 60 days to two years the post-death qualification period for (i) a grantor trust, and (ii) a trust with respect to stock transferred to it pursuant to the terms of a will. Under present law, a grantor trust or a Section 678 trust is a qualified shareholder for a two-year period after the

deemed owner's death if the entire corpus of the trust is includable in the gross estate of the deemed owner.

B. *Comments.* The 60-day period applicable under present law to grantor trusts and Section 678 trusts, the entire corpus of which are not includable in the gross estate of the deemed owner, is unnecessarily short and increases the risk that the corporation's S election will terminate. Grantor type trusts are commonly used for estate planning and probate avoidance purposes. The failure to transfer S corporation stock within the sixty (60) day period has been a frequent cause of inadvertent termination relief requests. cf. Private Letter Rulings 8839025 (June 29, 1988, as amended October 17, 1988), 8834033 (May 26, 1988), 8833041 (May 25, 1988), and 9001050 (October 11, 1989). By increasing the post death qualification period to two years, the trustee and beneficiaries will have sufficient time to alleviate the potential problem of maintaining the corporation's S election. The Section supports this amendment to Code section 1361(c)(2).

*Section 201—S Corporations Permitted to Issue Qualified Preferred Stock ("QPS").*

A. *Overview.* Section 201 of the Bill would amend Code section 1361 by adding a new subsection(f) to allow an S corporation to issue qualified preferred stock ("QPS") which is stock that (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium. The language of the Bill provides that no person shall be treated as a shareholder of the corporation by reason of holding QPS. Accordingly, QPS may be issued to a person who is not eligible to hold common stock of an S corporation. Under proposed Code section 1361(f)(3), a distribution (not in payment for the QPS) is includable interest income of the holder and deductible to the corporation as interest expense in computing taxable income under Code section 1363(b) in the year such distribution is received.

B. *Comments.* The provision authorizing preferred stock, permitting preferred stock to be held by otherwise ineligible shareholders, and permitting conversion of preferred stock into common stock will enhance the ability of S corporations to attract venture capital funds for business operations. Shareholders with different investment objectives may be accommodated while maintaining eligibility for S corporation treatment. The Section supports this provision.

It appears that upon conversion of shares of QPS into shares of common stock under the proposed amendments, the eligible shareholder limitations would come into play. This would result in the disqualification of the corporation for S corporation status if the holder of the shares upon conversion is not a permitted S corporation shareholder.

As illustrated in the following example, the language of proposed Code section 1361(c)(8)(C) appears to provide that the distribution of a QPS dividend by an S corporation is deductible as interest expense regardless of the source of the distribution.

Example—Corporation X, an S corporation, issues $1,000,000 of par value QPS to A. The QPS carries a 7 percent dividend rate. X invests $1,000,000 in a tax-exempt obligation yielding 7 percent. X's sole common shareholder is B. X has the following items of income and deduction for the taxable year:

$70,000 Tax-exempt interest
($70,000) QPS divided (deemed interest deduction)
$70,000 Other income

All of the above items, tax-exempt interest, QPS interest and other income are apparently passed through to B who may be permitted to use the deemed interest deduction to offset other taxable income, thus leaving B with tax-exempt interest income. The Section believes that the language of proposed Code section 1361(f)(3 should be drafted to avoid characterizing the deemed interest as "deductible" and to otherwise make the deduction subject to Code section 265(2). It is recommended that proposed Code section 1361(f)(3) be redrafted, in part, as follows:

"(3) Distributions.—A distribution (not in part or full payment in exchange for stock) made by the corporation shall be includable as interest income of the holder and *shall be treated as interest expense to the corporation for purposes of computing its taxable income under section 1363(b). Solely for purposes of section 265(a), qualified preferred stock shall be treated as indebtedness of the corporation issuing the qualified preferred stock.*"

Another potential issue arising under proposed Code section 1361(c)(8)(C) concerns the timing of the interest inclusion of the holder and the interest deduction of the S corporation. Under the proposed language, the "interest" income is includable as interest income of the holder and deductible to the corporation as interest

expense in computing taxable income under Code section 1363(b) *in the year such distribution is received.*

Example—A owns QPS in corporation X, an S corporation. A's taxable year ends November 30, and X's taxable year ends December 31. On December 31, 1994, A receives from X $100,000 as a dividend distribution on A's QPS. Is the distribution includable as interest income by A in his taxable year ending November 30, 1995 and deductible as interest expense by X in its taxable year ending December 31, 1995?

We recommend that the following sentence be added to Code section 1361(f)(3):

"(3) Distributions . . . . The interest income of the holder shall be includable, and any deduction of interest expense to the corporation under this chapter shall be allowable, as of the *taxable year of the holder and the corporation, respectively, in which occurs the date that the distribution is received by the holder.*"

*Section 202—Financial Institutions Permitted to Hold Safe-Harbor Debt, Certain Convertible Debt Characterized as Safe-Harbor Debt.*

A. *Overview.* Under present law, debt of an S corporation can qualify as safe-harbor debt only if the creditor is an individual (other than a nonresident alien) or an estate or a trust that is permitted to be an S corporation shareholder. Bill section 202 would expand the safe-harbor debt provision to additionally permit as creditors (i) nonresident alien individuals (permitted S corporation shareholders under the Bill) and (ii) persons actively and regularly engaged in the business of lending money.

Under present law, convertible debt cannot qualify as safe-harbor debt. Under proposed Code section 1361(c)(5)(B)(ii), a convertibility feature would not automatically disqualify debt as safe-harbor debt provided the terms of the debt arrangement, taken as a whole, are substantially the same as the terms which could have been obtained on the effective date of the arrangement from a person which is not a related person to the S corporation or its shareholders.

B. *Comments.* Like the new rule permitting preferred stock and the convertibility of preferred stock into common stock, the expanded definition of straight debt permitting holding of such debt by lending institutions and permitting a convertibility feature will enhance the ability of S corporations to attract venture capital. These provisions will allow an S corporation to pursue alternative sources of financing without risking its S status due to the one class of stock rule. The Section supports this change.

This problem is currently addressed in part under Regulations §§ 1.1361-(l)(4)(iii) and (iv). Under the Regulations, convertible debt is treated as a second class of stock if (i) the instrument constitutes equity under general principles of federal tax law and a principal purpose of issuing the instrument is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding stock or to circumvent the limitation on eligible shareholders, or (ii) the convertible debt embodies rights equivalent to those of a call option that would be treated as a second class of stock under Regulations § 1.1361-1(l)(4)(iii). Generally, a call option is treated as a second class of stock if (i) the call option is substantially certain to be exercised by the holder or a potential transferee, and (ii) has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued, transferred to a person that is not an eligible shareholder of an S corporation or materially modified. However, under Regulations § 1.1361-1(l)(4)(iii)(B), a call option is not treated as a second class of stock if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This latter provision is similar to the proposed expanded straight debt safe-harbor provision.

*Section 211—Rules Relating to Inadvertent Terminations and Invalid Elections; Late Elections.*

A. *Overview.* Under present law, if the Service determines that an S election is inadvertently terminated, the Service can waive the effect of the terminating event, provided appropriate adjustments are made that are consistent with the position that no termination occurred. Otherwise, the loss of S status would expose a re-electing corporation to the built-in gains tax for the ten year recognition period after re-election, and possibly the tax on excess passive investment income.

Bill section 211(a) provides relief to corporations electing S status by expanding Code section 1361(f) to allow the Service to treat inadvertent invalid elections as effective. Bill section 211(b) provides further relief to electing corporations by providing the Service with authority to treat late elections as timely if the Service de-

termines that there was reasonable cause for the failure to timely make the S election.

Under Bill section 211(c), the Service is directed to provide an automatic waiver procedure for inadvertent invalid elections or inadvertent terminations under Code section 1362(f) in cases the Service deems appropriate. The authority to grant automatic relief does not apply to late elections.

Under Bill section 211(d), the amendments made by Bill sections 211(a) [waiver for inadvertent invalid elections or inadvertent terminations], and 211(b) [waiver for late elections] apply with respect to terminations or elections for taxable years beginning after December 31, 1982. Section 401 of the Bill provides that except as otherwise specifically provided, the amendments made by the Bill shall apply to taxable years beginning after December 31, 1995.

B. *Comments.* While the Service has announced areas in which inadvertent termination relief is automatic (i.e., Rev. Proc. 94-23 with respect to late QSST elections), the time and expense required to request inadvertent termination relief is an unnecessary burden. Further, no relief has ever been provided for the waiver of a defective S election or a late election, even where such failure results from inadvertent error. The Section supports the expansion of the scope of existing Code section 1362(f).

Since the special effective date provision of Bill section 211(d) does not specifically reference Bill section 211(c), the automatic waiver procedure would not apply to an inadvertent invalid election or inadvertent termination occurring in a taxable year beginning before January 1, 1995. It is suggested that the automatic waiver procedure should be available for any taxable year beginning after December 31, 1982.

*Section 212—Election to Treat Taxable Year as Two Taxable Years If Shareholder Terminates Interest in the Corporation.*

A. *Overview.* Under present Code section 1377(a)(2), the election to close the books for purposes of determining the income or loss allocable to a shareholder who terminates his interest in the S corporation requires the consent of the terminated shareholder and all other persons who were shareholders of the S corporation during the taxable year of termination. Bill section 212 amends Code section 1377(a)(2) to provide that in the case of the termination of a shareholder's interest in the corporation, the year can be closed upon agreement of all of the "affected" shareholders. With respect to a transfer from a shareholder to a person other than the corporation, the "affected" shareholders include the transferor and any persons to whom the transferor transfers shares during the taxable year. Where the stock of the terminating shareholder is acquired by redemption, all shareholders would be required to consent.

B. *Comments.* This provision is intended to streamline the procedure for the election to close the books upon the termination of a shareholder's interest in an S corporation. The Section supports this change.

*Section 213 (a) and (b)—Expansion of the Post-Termination Transition Period ("PTTP").*

A. *Overview.* Section 213 of the Bill would amend the Code to expand the definition of the PTTP under Code section 1377(b) to the end of the 120 day period after a determination pursuant to an audit of the taxpayer occurring after the termination of its S election and which adjusts items of income, loss or deduction of the corporation arising during the S period.

As proposed, Code section 1377(b)(1)(B) applies to audit adjustments of Subchapter S items relating to the S period (as defined in Code section 1368(e)(2)), that is, the most recent continuous period during which the corporation has been an S corporation.

B. *Comments.* It is recommended that the provision be expanded so that the PTTP should apply to audit adjustments relating to any S period, not only the most recent S period.

It is also suggested that Code section 1366(d)(3) be amended to permit a taxpayer to treat suspended losses as incurred on the date of an adjustment to basis required as a result of an IRS audit. Under the current provisions of Code section 1366(d)(3), if a loss or item of deduction arising during the last taxable year of the S election is disallowed upon subsequent audit because of insufficient basis in stock or debt, the loss is treated as incurred by the shareholder on the last day of any PTTP. Thus, if stock is transferred prior to the last day of the PTTP, the transferor shareholder would not be entitled to PTTP relief with respect to any losses attributable to the transferred shares. It is recommended that Code section 1366(d)(3) be amended to treat the losses as incurred by the shareholder on the earlier of (i) the last

day of any PTTP, or (ii) the last day on which the shareholder owns the stock to which the loss or deduction is attributable.

*Section 213(c)—Repeal of Special Audit Provisions for Subchapter S Items.*

A. *Overview.* Bill section 213(c) would repeal the corporate level audit provisions (Code sections 6241-6245) currently applicable to S corporations and their shareholders. Consistency provisions analogous to the partnership consistency provisions of Code section 6222 would be added as new Code section 6037(d). In effect, this provision of the Bill would eliminate the requirement that the tax treatment of any subchapter S item be determined at the corporate level and further eliminate the entity level procedures for S corporations. The provisions that obligate shareholders to file a return that is consistent with the corporate return or to provide notice of the inconsistency would be retained.

B. *Comments.* Under present law, the tax treatment of subchapter S items, with certain specified exceptions, is determined at the corporate level. The shareholder must treat each item in a manner that is consistent with the treatment of such item on the corporate return, unless the shareholder files a notice of inconsistent treatment. Administrative and judicial proceedings with respect to any deficiencies arising from the tax treatment of subchapter S items are conducted in unified proceedings for all shareholders at the corporate level.

A "subchapter S item" is defined in Code section 6245 as "any item of an S corporation to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the corporate level than at the shareholder level." An item that the S corporation is not required to determine at the corporate level cannot be a subchapter S item. See *Dial USA, Inc.* v. *Commissioner,* 95 T.C. 1 (1990).

The tax treatment of items that are not subchapter S items are not determined in the corporate level proceeding but must be determined in a separate shareholder level proceeding. The decisions in a corporate level proceeding, insofar as the corporate level proceeding resolves issues that may arise in a subsequent shareholder level proceeding, are binding and res judicata in the subsequent shareholder level proceeding.

The provisions that govern entity level audits of a partnership create a tax matters partner ("TMP") to act as the central figure in the entity level audit. The TMP is the liaison between the Service and the other partners. Code section 6223(g) imposes on the TMP the obligation of furnishing the partners certain information. In addition, the TMP has the ability to file a request for administrative adjustment that can be treated as a substitute for the partnership's return or, if not allowed, give rise to a right of judicial review. The TMP can also choose the forum for judicial review of a final partnership administrative adjustment. In the case of a partnership, the TMP is a general partner, unless no general partner is designated as TMP and it is impractical to treat the general partner with the largest profits interest as the TMP.

The entity-level audit provisions for S corporations incorporate by reference the requirement of a TMP. There have, however, been no regulations explaining how the concept of a TMP is to be applied in the case of an S corporation. In *Gold-N-Travel Inc. v. Commissioner,* 93 T.C. 618, 622 (1989), the Tax Court suggested that, in the absence of a prior designation of a shareholder as a TMP and until regulations are promulgated, the designation of a person to act in a capacity analogous to a TMP should be as follows: "[T]he shareholder with the largest profit interest in the year involved is the TMP [person who acts in a capacity analogous to a tax matters partner]. If more than one shareholder falls into this category, the person whose name would appear first in an alphabetical listing is the TMP. If that person refuses to act, the Secretary may designate another shareholder as TMP or any other shareholder may so act." The Tax Court has held that a president of an S corporation cannot act for the S corporation in a capacity analogous to a TMP unless he is also a shareholder. Id.

Temporary Treasury Regulations (Temp. Treas. Reg. §301.6241-1T(c)(2)) that are effective for taxable years of S corporations for which the due date of the return is on or after January 30, 1987, exempt all small S corporations, defined as those with five or fewer shareholders, each of whom is a natural person or an estate, from the requirement that subchapter S items be determined at the corporate level. The determination of whether an S corporation has had five or fewer shareholders is made on an annual basis. Notwithstanding its exemption from the corporate level procedures, a small S corporation may elect to have the provisions of the corporate level audit made applicable. The election, once made, is revocable only with the consent of the Commissioner. Approximately 95% of all S corporations are subject to this exemption for small S corporations.

Present law creates the potential for two separate proceedings to resolve a dispute with respect to income arising from an S corporation, one at the corporate level for subchapter S items and one at the shareholder level for those items that are no subchapter S items.

The application of the partnership procedures to S corporations, particularly the provisions that designate a TMP, does not work well. A corporation does not have a person analogous to a general partner who is both an agent for the other partners and liable for the actions of the entity. The necessity to designate a shareholder to act in a capacity analogous to a TMP disregards the corporate structure and may leave shareholders at risk that their interests will not be adequately protected.

The repeal of the corporate level audit provisions would permit a shareholder's liability to be determined in one proceeding. The Section supports this change. It subjects all S corporations to the same rules, thereby avoiding any added complexities of only very limited application. It is simple and straightforward. It also eliminates any need for a shareholder to be arbitrarily designated to act in a capacity analogous to a tax matters partner of a partnership.

There is no evidence that the Service has found the traditional shareholder level audit procedure for S corporations unmanageable. The recommendation in the Joint Internal Revenue Service-Treasury Department Study that the unified audit procedures not be applicable to S corporations confirms that the application of the small S corporation procedures to S corporations with more than five shareholders should not be burdensome. To the extent the repeal of the corporate level audit provisions creates the risk of inconsistent treatment of different shareholders, such inconsistent treatment may be appropriate given the different risks associated with litigation for each shareholder. The possibility of different tax treatment of partnership items and subchapter S items is already accepted as an appropriate risk in small partnerships and small S corporations.

*Section 214—Repeal of Excess Passive Investment Income as a Termination Event.*

A. *Overview.* Section 214 of the Bill would repeal Code section 1362(d)(3), which terminates an S election of a corporation with C earnings and profits which receives excess passive investment income for three consecutive years. The Bill increases the threshold at which the PII sting tax can apply from PII constituting more than 25% of gross receipts to PII constituting more than 50% of gross receipts.

However, under proposed Code section 1375(c)(1), the rate of the sting tax imposed on the corporation's excess net passive income would be significantly increased beginning in the fourth consecutive taxable year in which the corporation has C earnings and profits at the close of such taxable year and gross receipts more than one-half of which are PII. The rate of the sting tax is the highest corporate rate of tax in the third consecutive taxable year plus (i) 10 percentage points in the fourth consecutive year, and (ii) an additional 10 percentage points each consecutive year thereafter until the eighth consecutive taxable year and thereafter, when 50 percentage points are added to the highest corporate rate existing in the third consecutive year.

Under present Code section 1362(d)(3)(D)(i), PII includes gross receipts derived from sales or exchanges of stock or securities only to the extent of gains therefrom. Under section 214 of the Bill, the definition of PII would be moved to Code section 1375(b)(5) (redesignated Code section 1375(b)(4)), and PII would not include gains from sales or exchanges of stock or securities.

Bill section 221(b) would add proposed Code section 1375(b)(5)(F) which provides that if the S corporation receives dividends from an affiliated C corporation (that is, a C corporation in which the S corporation owns stock having 80 percent of the total voting power of the C corporation and 80 percent of the total value of stock of such corporation), then PII does not include dividends from such C corporation to the extent such dividends are attributable to the earnings and profits of such C corporation derived from the active conduct of a trade or business.

B. *Comments.* The Section supports the repeal of the rules terminating S status for a corporation receiving excess passive investment income and having C earnings and profits. This provision will facilitate more C to S conversions by eligible corporations that derive a substantial portion of their income from passive sources. If such corporations are not able to convert to S status, they would remain subject to the special taxes on undistributed personal holding company income and unreasonable accumulation of earnings.

The Bill provides further relief by increasing the threshold required to trigger the tax on excess passive investment income under Code Section 1375 from 25% to 50%. If the corporation was subject to Code section 1375 for three consecutive years, however, the rate of tax on excess passive investment income is increased by ten percentage points per year after year 3. Assuming a maximum corporation level rate

of 34%, the tax on an S corporation's excess passive investment income in the fourth consecutive year would increase to 44%. The additional tax reaches a maximum rate of 84% in the eighth consecutive year of excess passive investment income.

The language of the Bill excludes gross receipts from sales or exchanges of stock or securities from the definition of passive investment income. The proposed language fails to address whether the amount of the gross sales price from the sale or exchange of stock or securities (less commissions) would be treated as gross receipts. The present regulations provide that gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Reg. § 1.1362-2(c)(4)(ii)(B). The failure to limit the treatment of sales of stock or securities as gross receipts to the gains rather than the entire proceeds may permit manipulation of the sting tax, as illustrated by the following example:

Example—X, an S corporation with accumulated C earnings and profits has $100,000 of interest income for the taxable year. The only other transaction of X for the taxable year consists of X's purchase of $200,000 Bell South stock on December 1 and the sale of such Bell South stock on December 2 for $200,000.

Threshold test—

PII $100,000

Total gross receipts $100,000 + 200,000

33.33%

Accordingly, X is not subject to tax under proposed Code section 1375 because the S corporation does not have gross receipts more than 50% of which are PII.

It is suggested that the provisions of the existing regulations be incorporated into the proposed statutory language of Code section 1375(b) defining gross receipts, as follows:

(5) Sales of stock or securities. In the case of dispositions of stock or securities, gross receipts from such dispositions shall be taken into account only to the extent of gains therefrom.

Paragraph (5) of subsection 1375(b), defining PII, would be renumbered paragraph (6).

In connection with the rate of sting tax applicable to the fourth consecutive taxable year, it is not clear why the base rate is the highest corporate rate of tax existing in the third consecutive taxable year. It is recommended that the language in proposed Code section 1375(b)(1) providing that the rate of tax imposed under Code section 1375(a) shall be equal to: "such rate of tax for the 3rd taxable year, plus . . . ." be changed to "[t]he highest rate of tax specified in section 11(b) for the taxable year, plus . . . ."

*Section 221—S Corporation Permitted to Hold Subsidiaries.*

A. *Overview.* Section 221(a) of the Bill amends Code section 1361(b) to provide that a corporation would no longer be classified as an "ineligible corporation" and thus unable to elect or retain S status by reason of owning stock possessing 80 percent or more of (i) the total voting power of stock of another corporation and (ii) the total value of stock of such corporation. Although the S corporation would be a member of an affiliated group, under proposed Code section 1504(b)(8), it would be excepted from the definition of an "includable corporation" for purposes of filing a consolidated return.

Section 221(b) of the Bill amends Code section 1361(b) by adding a new subsection (3) providing for a "qualified subchapter S subsidiary." A "qualified subchapter S subsidiary" is defined as a corporation 100% of the stock of which is held by an S corporation as of the later of the effective date of the S election of the S corporation or the acquisition of the subsidiary, and at all times thereafter. A qualified subchapter S subsidiary will not be treated as a separate corporation and all assets, liabilities and items of income, deduction and credit are treated as assets, liabilities and items of income, deduction and credit of the S corporation parent. Provisions are made for the termination of qualified subchapter S subsidiary status, in which event the corporation shall be treated as a new corporation acquiring all of its assets and assuming all of its liabilities immediately before the cessation of such status.

Bill section 221(b) also provides that certain dividends from a C corporation affiliate of the S corporation are not treated as passive investment income to the S corporation.

B. *Comments.* The Bill reverses the long standing rule that an S corporation cannot be a member of an affiliated group, and thus permits an S corporation to own any percentage of a C Corporation and 100% of another S corporation. The Section supports this change.

The qualified subchapter S subsidiary follows the analogy of Code section 856(i) which permits a REIT to own all of the interests of a controlled REIT subsidiary, with the assets and liabilities and items of income, loss, deduction and credit of the subsidiary being treated as assets, liabilities, and items of income with respect to the parent. Transactions between the S corporation parent and subsidiary would not be taken into account and the tax attributes of the subsidiary (including C earnings and profits, passive investment income, built-in gains, etc.) would be considered tax attributes of the parent. If a subsidiary ceases to be a qualified S corporation subsidiary, the former subsidiary would be treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock immediately before it ceases to be a qualified S corporation subsidiary.

It is suggested that the language of the Bill should be clarified to confirm that an S corporation can own a wholly-owned C subsidiary or a wholly-owned qualified subchapter S subsidiary. To this end, the Section would suggest that a "qualified subchapter S subsidiary" be defined as "an S corporation 100% of the stock of which is held by an S corporation . . . "

*Section 222—Treatment of Distributions During Loss Years.*

A. *Overview.* Section 222 of the Bill would amend Code sections 1366 and 1368 to provide that before determining the tax treatment of distributions to S corporation shareholders, the basis of the distributee shareholder in the S corporation stock would increase by the amounts described in Code section 1367(a)(1) for the taxable year in which the distribution occurs (separately stated items of income, nonseparately computed income, excess of deductions for depletion over basis of property subject to depletion and excess of deduction for charitable contributions over the basis of the property contributed) but would not decrease by the amounts described in Code section 1367(a)(2) (separately stated items of loss and deduction, nonseparately computed loss, expenses of the corporation not deductible in computing its taxable income and not properly chargeable to capital account and the shareholder's deduction for depletion of oil and gas properties to the extent such deduction does not exceed the adjusted basis of such property allocated to the shareholder). Also, for purposes determining the corporation's AAA available to cover distributions made during the taxable year, the amount of AAA as of the close of the taxable year will be determined without regard to any net negative adjustment, i.e., the excess of reductions to AAA for the taxable year (other than reductions for distributions) over increases to AAA for the taxable year.

B. *Comments.* The current regulations under Section 1367 establish ordering rules for adjustments to the basis of a shareholder's S corporation stock. Increases in basis for income items and decreases in basis for non-deductible expenses, oil and gas depletion, and deductible losses, are made prior to the decrease in basis attributable to distributions by the corporation with respect to its stock. These ordering rules may result in distributions during loss years being treated as taxable distributions when made without accurate information with respect to whether the current year is a loss year. a The legislative history of the SSRA with respect to this issue is contradictory. On the one hand, the Committee Reports indicate that the S corporation rules for adjusting basis should be analogous to those provided for partnerships, which adjust basis first for distributions and then for losses and deductions. On the other hand, the Committee Reports state that "income and loss for any corporate taxable year will apply to adjust basis before the distribution rules apply for that year." S. Rep. No. 640, 97th Cong. 2d Sess. 18, reprinted in 1982-2 C.B. 718, 726, H.R. Rep. No. 826, 97th Cong. 2d Sess. 17, reprinted in 1982-2 C.B. 730, 738. In addition, the language of the loss limitation rule of Code section 1366(d)(1) suggests that losses are to be applied against basis before distributions are accounted for.

The Section supports the clarification of this issue by the amendment of Code sections 1366 and 1368. However, there are technical problems with the proposed language designed to adjust the distributee shareholder's stock basis for loss years prior to determining the tax effects of distributions. The language of proposed Code section 1368(d) as amended by Bill section 223(a)(2) states:

"(d) Certain adjustments taken into account.

Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

*In the case of any distributions made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year."*

It is not clear that the proposed language accomplishes the intended result since the immediately preceding language specifically states that "Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—(1) the adjustments to the basis of the shareholder's stock described in section 1367 . . . ." To clear up any ambiguity, it is recommended that the proposed language be drafted as follows:

"(d) Certain adjustments taken into account.

Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

*Notwithstanding the foregoing provision, in the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined without regard to the adjustments provided in paragraph (2) of section 1367(a) for the taxable year."*

*Section 223—Consent Dividend for AAA Bypass Election.*

A. *Overview.* Section 223 of the Bill would add Code section 1368(e)(3)(C) which would allow an S corporation, under regulations prescribed by the Secretary, to elect with the consent of the shareholders to treat an amount not to exceed its accumulated earnings and profits as distributed to the shareholders on the last day of the corporation's taxable year and as contributed by the shareholders to the corporation's capital on such last day (a "consent dividend"). Proposed Code section 1368(e)(3)(C)(ii) would also specify that for any shareholder that is a qualified retirement plan or tax-exempt organization, the consent dividend would be treated as unrelated business taxable income.

B. *Comments.* Regulations § 1.1368-1(f)(3) currently allows an S corporation to make a consent dividend with the consent of each shareholder to whom a distribution is deemed to be made during the taxable year. With respect to a consent dividend, if the deemed recipient of such consent dividend is a qualified retirement plan or a section 501(c)(3) organization, the consent dividend is treated as unrelated business taxable income to the stockholder. Presumably this is an anti-abuse provision designed to prevent parking S corporation stock with a qualified retirement plan or section 501(c)(3) organization for purposes of stripping the S corporation's accumulated earnings and profits through a consent dividend. Nevertheless, it appears that this provision is overbroad. For example, if the exempt shareholder is a historical shareholder and provided that the shares are not debt-financed property, a dividend distribution to the shareholder while the corporation was a C corporation would not have been treated as UBTI. See Code section 512(b)(1).

Accordingly, while the Section supports this provision, it is suggested that proposed Code section 1368(e)(3)(C)(ii) should be drafted to exclude from UBTI that portion of the consent dividend relating to accumulated earnings and profits accumulated while the qualified retirement plan or section 501(c)(3) organization was a shareholder of the corporation.

*Section 224—Permit Subchapter C to Apply to S Corporations.*

A. *Overview.* Section 224 of the Bill would repeal present Code section 1371(a)(2) which provides that for purposes of Subchapter C, an S corporation in its capacity as a shareholder of another corporation is treated as an individual. As a result of this change, among others, (i) the S corporation could liquidate a qualified subsidiary without recognition of gain or loss on the receipt of the liquidating distribution (Code section 332), (ii) the liquidating subsidiary of the S corporation could liquidate without the recognition of gain or loss (Code section 337), and (iii) an S corporation will be allowed to make a Code section 338 election in connection with a qualified stock purchase.

B. *Comments.* In GCM 39768 (December 1, 1988), the Service acknowledged that Code section 1371(a)(2) did not prevent an S corporation from engaging in a tax-free reorganization or division under Code section 1368(a)(1). However, the Service took the position in Private Letter Ruling 8818049 (February 10, 1988) that an S corporation could not engage in the purchase of a target corporation's stock under Code section 338 or liquidate a controlled subsidiary under Code sections 337 and 332. The Service now takes the position that such qualified stock purchases and subsidiary liquidations *may be made* by an S corporation. Technical Advice Memorandum 9245004 (July 28, 1992). The Section supports the repeal of Code section 1371(a)(2) to remove any statutory ambiguity.

*Section 225—Elimination of Pre-1983 Earnings and Profits Which Were Accumulated in Any Taxable Year in Which the Corporation Was an Electing Small Business Corporation Under Subchapter S.*

A. *Overview.* Section 225 of the Bill would amend the Code to eliminate the references to earnings and profits which were accumulated in any taxable year in which the corporation was an electing small business corporation under subchapter S prior to the effective date of the SSRA. Specifically, if a corporation was an electing small business corporation under subchapter S for any taxable year beginning before January 1, 1983, then provided the corporation is an S corporation for its first taxable year beginning after December 31, 1995, the amount of the corporation's accumulated earnings and profits (as of the beginning of the first taxable year beginning after December 31, 1995) would be reduced by an amount equal to the portion (if any) of such accumulated earnings and profits which were accumulated in any pre-1983 taxable years for which such corporation was an electing small business corporation under subchapter S.

B. *Comments.* Under present law, the accumulated earnings and profits of a corporation are not increased for any post-1982 year for which an S election is in effect. However, an S corporation may have earnings and profits attributable to subchapter C years and further may have earnings and profits attributable to subchapter S years prior to 1983. The corporation may desire to purge itself of C earnings and profits in order to avoid the tax on excess net passive investment income under Code section 1375, or, under present law, to avoid the termination of the S election under Code section 1362(d)(3). The corporation may elect under the regulations to bypass AAA to distribute C earnings and profits or to make a "deemed distribution" of C earnings and profits in order to avoid the tax on excess passive investment income. Pre-1983 subchapter S earnings and profits are not relevant for these purposes. Since there is no other tax implication of pre-1983 subchapter S earnings and profits, the Section supports the elimination of the concept and the avoidance of the need to account for pre-1983 S corporation earnings and profits.

*Section 226—Allowance of Charitable Contributions of Inventory and Scientific Property.*

A. *Overview.* Generally, in connection with a donation of property to a charity, a taxpayer's charitable deduction is reduced by the amount of gain that would not have been long-term capital gain if the taxpayer had sold the property. However, Code sections 170(e)(3) and 170(e)(4) limit the charitable deduction reduction applicable to C corporations in connection with, respectively, a donation of certain property to be used for the care of the ill, the needy or infants, or a donation of scientific property to be used for research. Section 226(a) of the Bill amends Code section 170(e)(1) to provide that S corporations would be treated the same as C corporations with respect to charitable contributions of (1) certain inventory used by the donee solely for the care of the ill, needy, or infants (Code section 170(e)(3)(B)) or (2) certain scientific property used for research (Code section 170(e)(4)). This results in a cap on the reduction of the deduction by the donor for the fair market value of the property contributed to a charitable organization (the deduction is normally reduced by the amount of gain that would not have been long term capital gain had the property been sold by the donor). The limitation on the reduction of the deduction is the sum of (1) one-half of the amount of gain that would not have been long term capital gain had the property been sold and (2) the amount (if any) by which the charitable deduction (determined by taking into account the amount described in (1)) exceeds twice the basis of the property.

Section 226(b) of the Bill amends Code section 1367(a)(1)(D) to provide for an increase in the shareholder's basis of S corporation stock for the amount by which the deduction for the charitable contribution exceeds the basis of the property contributed by the corporation.

B. *Comments.* The Section supports the amendment of Code section 170(e) to provide that S corporations would be treated the same as C corporations with respect to charitable contributions of certain inventory used by the donee solely for the care of the ill, needy or infants and certain scientific property used for research. The Section further supports the amendment of Code section 1367(a) to allow an increase in the basis of S corporation stock for the excess of the deduction for the charitable contribution over the basis of the property contributed by the corporation.

Charitable contributions by an S corporation are not deductible by the S corporation, but pass-through to the shareholders as a separately stated item under Code section 1366(a)(1)(A). The pass-through of deductions is limited under Code section 1366(d)(1) to a shareholder's basis in his stock and debt. If the shareholder does not have sufficient basis, disallowed losses and deductions are carried over under Code section 1366(d)(2). If an S corporation makes a charitable contribution of appre-

ciated property, it is not unusual for the basis limitation to come into play. By allowing S corporation shareholders to increase basis by the excess of the deduction for charitable contributions over the basis of contributed property, it is unlikely that a shareholder's charitable contribution deduction will be limited by the basis limitation.

*Section 227—C Corporation Rules to Apply for Fringe Benefit Purposes.*

A. *Overview.* Section 227(a) of the Bill would repeal Code section 1372. Under Code section 1372, for purposes of the provisions of the Code relating to employee fringe benefits (i) the S corporation is treated as a partnership, and (ii) any 2-percent shareholder of the S corporation is treated as a partner of such partnership. Section 227(b) of the Bill would amend Code section 162(l) to provide that the partnership rules would continue to apply to health insurance costs of a 2-percent shareholder-employee of an S corporation. Accordingly, payments for accident and health insurance coverage provided to the 2-percent shareholder-employee under an S corporation's accident and health plan would be treated as such shareholder's earned income and would not be excludable from the 2-percent shareholder-employee's income under Code section 106. Under Code section 162(l), a 2-percent shareholder, treated as self-employed under the partnership rules, may deduct 30 percent of the amount paid during the taxable year for such insurance payments. As a result of the repeal of Code section 1372, S corporations and their 2-percent shareholders would be treated in the same manner as C corporations and their shareholders under the other fringe benefit provisions of the Code.

B. *Comments.* Code section 1372 treats each "2-percent shareholder" in an S corporation as a partner in a partnership for purposes of applying the provisions of the Code relating to certain employee fringe benefits. In many cases, this rule can provide harsher treatment for S corporation shareholder/employees than for partners in a partnership, since Code section 1372 is applied with application of the constructive ownership provisions section 318. For example, an S corporation employee, who is not a shareholder, but who is related to a shareholder, would be subject to the limitations of Code section 1372.

The Bill proposes the repeal of Code section 1372, effectively returning the law to its pre-SSRA status with respect to fringe benefits other than health insurance costs. The "employment relationship" between an S corporation and its shareholder/employee is much more like the employee/shareholder than it is between a partner and a partnership to which that partner provides services. In the corporate context, a true employer/employee relationship exists, as contrasted with the fiduciary relationship between a partner and a partnership under state law. The application of the employee fringe benefit provisions of the Code to S corporation employee/shareholders should respect the bona fide employment relationship. On the other hand, health insurance costs paid by an S corporation for the benefit of 2 percent shareholders will be subject to the same treatment allowed partners in a partnership.

*Section 301—Uniform Treatment of Owner-Employees Under Prohibited Transaction Rules.*

A. *Overview.* This provision amends Code section 4975(d) to permit more-than-5% shareholder employees of an S corporation to be eligible for exemption from the prohibited transaction rules applicable to qualified plans. As a result, a more-than-5% shareholder would be eligible to borrow money from a qualified plan sponsored by the S corporation provided that the requirements for participant loans under Code section 4975(d)(1) are satisfied.

B. *Comments.* The Section supports the amendment of Code section 4975(d) to bring the prohibited transaction rules for more than 5% shareholder employees of an S corporation in line with the rules for shareholders and employees of C corporations, with the result that a more than 5% shareholder would be eligible to borrow money from a qualified retirement plan sponsored by the S corporation under the normal exemption from the prohibited transaction rules for participant loans under Code section 4975(d)(1) (i.e., up to $50,000 or one-half of the balance to the credit of the participant's account).

*Section 302—Treatment of Losses to Shareholders on Liquidation.*

A. *Overview.* Section 302 of the Bill would amend Code section 331(c) to provide that a loss recognized by an S corporation shareholder on amounts received by the shareholder in a distribution in complete liquidation of the S corporation is treated as an ordinary loss to the extent of the shareholder's "ordinary income basis" in the S corporation stock. The "ordinary income basis" of the shareholder is an amount equal to the portion of such shareholder's basis in such stock which is equal to the aggregate increases in such basis under Code section 1367(a)(1) resulting from the

shareholder's "pro-rata share of ordinary income of such S corporation attributable to the complete liquidation."

B. *Comments.* The language defining ordinary income basis may be drafted too narrowly since it can be interpreted to encompass only ordinary income recognized upon a distribution of property in complete liquidation of the corporation. Ordinary income basis should also include ordinary income recognized in connection with sales or exchanges of S corporation property that arise pursuant to pre-liquidation dispositions.

It is suggested that the adoption of a concept similar to that contained in Code section 453(h)(1), i.e., include ordinary income recognized upon a sale or exchange of property by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted provided that all of the assets of the corporation are distributed in complete liquidation within such 12-month period.

In certain circumstances, the language of proposed Code section 331(c) may provide unintended benefits, summarized in the following example:

Example - X, an S corporation has 3 assets:

| | Adj. Basis | FMV |
|---|---|---|
| Land | $ 2,000,000 | $ 1,000,000 |
| Inventory (1) | 1,000,000 | 2,000,000 |
| Inventory (2) | 2,000,000 | 1,000,000 |
| TOTAL | $ 5,000,000 | $ 4,000,000 |

A, X's sole shareholder, has $6,000,000 basis in his S corporation stock.

On liquidation of X -

| | | |
|---|---|---|
| Land | ($1,000,000) | capital loss |
| Inventory (1) | 1,000,000 | ordinary income |
| Inventory (2) | (1,000,000) | ordinary loss |
| TOTAL | ($1,000,000) | |

A's stock basis - $6,000,000 - 1,000,000 + 1,000,000 - 1,000,000 = $5,000,000.

Loss on liquidation - $1,000,000.

Proposed Code section 331(c) arguably treats the loss as ordinary loss. In this respect, the gain on the sale of Inventory (1) and the loss on sale of Inventory (2) arguably are not netted under Code section 1366(a)(1)(B) and are separately stated under Code section 1366(a)(1)(A) because the separate treatment of those items could affect the liability for tax of any shareholder.

It is suggested that the definition of "ordinary income basis of stock of an S corporation" be expanded as follows:

> " . . . the aggregate increases in such basis under section 1367(a)(1) resulting from such shareholder's pro rata share of ordinary income of such S corporation attributable to *(i)* the complete liquidation, and *(ii) sales of assets by the corporation (other than in the ordinary course of business) during the twelve month period preceding the distribution.*"

*Section 401—Effective Date.*

A. *Overview.* Section 401(a) of the Bill provides that except as otherwise specifically provided in the Bill, the amendments made by the Bill shall apply to taxable years beginning after December 31, 1995. Section 401(b) of the Bill provides that any termination of an S election by revocation or otherwise under Code section 1362(d) as in effect prior to the enactment of the Bill shall not be taken into account for purposes of determining whether the corporation or its successor is eligible to

make an S election before the 5th taxable year after the termination under Code section 1362(g) without the consent of the Secretary. In other words, a corporation which had terminated its election under present law would be eligible to re-elect S status under the new law before the expiration of the 5 year period under Code section 1362(g) without requesting the Secretary's consent.

B. *Comments.* Except for the comment with respect to the effective date of Bill section 211(c) relating to the applicability of the automatic waiver procedure to inadvertent invalid elections or inadvertent terminations occurring during years beginning prior to January 1, 1995, the Section concurs with the appropriateness of the general effective date provisions of the Bill. In addition, the disregard of terminations of prior elections prior to the effective date of the Bill for purposes of the five year re-election limitations will permit S corporations to re-elect S status in light of the eligibility and qualification rules of the new law without requesting the consent of the Secretary or qualifying for the limited automatic consent upon certain terminations under the present regulations.

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## STATEMENT OF THE AMERICAN VINTNERS ASSOCIATION

(SUBMITTED BY ROBERT G. KALIK, PRESIDENT)

This testimony is submitted on behalf of the American Vintners Association, the national trade association of American Wineries with a membership of over 450 wineries in 38 states, to express our strong support of S.758, the "S Corporation Reform Act of 1995."

There are over 1,400 American wineries located in forty-six states producing wine with a retail value of over 12 billion dollars annually. The overwhelming majority of these wineries are family-owned, small business farm wineries. These wineries generate tourism, protect marginal farm land from development, help familiarize many city and suburban residents to farms and farming, and provide rural employment opportunities for both skilled and unskilled workers. Besides California, such diverse states as Washington, Oregon, New York, Ohio, Maryland, Virginia, Texas, Colorado, Michigan and Missouri have experienced a huge surge in winery numbers, popularity and prestige.

According to an AVA survey of its membership, approximately 40% of wineries are S corporations, a ratio which we believe reflects national statistics for all businesses. Cakebread Cellars, a member winery located in the Napa Valley is not untypical of winery S corporations. The Cakebread Cellars winery was founded by Jack Cakebread and his wife in 1973. In the evolution of its growth over the last twenty-two years, their business has been joined by two sons and three daughter-in laws. The winery has been a great success growing in size and achieving critical acclaim for the quality of its products. But the business and financial challenges faced by Cakebread Cellars are huge and compromised by the inflexibility of current S corporation law.

Financing ongoing business needs, exacerbated by the need to replant vineyards because of infestation of a small root feeding insect known as phylloxera, has been especially difficult because S corporation law has severely limited the corporation's ability to raise equity capital. The reforms contained in S.758 would permit Cakebread to issue preferred stock and convertible debt, and increase the number of allowed shareholders. These changes would greatly improve Cakebread Cellars' ability to raise the capital need to continue building the business.

Changes proposed to S corporation law broadening the type of trusts which may own S corporation stock would greatly facilitate keeping family businesses alive and within the family upon the death of the first generation. In the absence of the flexibility contained in the reform legislation, the Cakebread family, as well as the overwhelming majority of

S corporation founders, have had to devote an inordinate amount of time and effort to non-productive, complex, succession planning essential to avoid a forced sale of the business upon the death of the founders in order to satisfy tax obligations.

S corporations were designed as a vehicle for family-owned businesses. Current law too often leads to sale of the business rather than continuation of family ownership. This should be remedied. In these times, when the nation's priorities are focusing on individual economic initiative and family cohesiveness, S corporations are more than ever a desirable mechanism for facilitating those goals. Hundreds of wineries and hundreds of thousands of other family businesses, need sensible reform of current S corporation law. The American Vintners Association thanks you for the opportunity to submit this testimony and urges swift passage of S. 758.

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STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

*Washington, DC, June 19, 1995.*

Hon. ORRIN HATCH,
*Chairman,*
*Subcommittee on Taxation and IRS Oversight,*
*Senate Finance Committee,*
*U.S. Senate,*
*Washington, DC*

Dear Chairman Hatch: The Associated General Contractors of America (AGC) is a national trade association of more than 33,000 firms, including 8,000 of America's leading general construction contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development.

AGC welcomes the opportunity to provide this statement of support to the Subcommittee on Taxation and IRS Oversight regarding S. 758, the S. Corporation Reform Act of 1995. AGC respectfully requests that this statement be made a part of the record of the Subcommittee's proceedings on June 19, 1995.

Over 1.6 million businesses operate as S. Corporations in the United States. AGC represents many of these S. Corporations. These S. Corporations are family-owned business that adhere to the tax laws and work hard to prosper in a competitive business environment. However, these firms often find it difficult to succeed and grow further because of a number of unnecessary and antiquated obstacles.

AGC believes that now is the time to remove these obstacles and promote capital formation for our nation's businesses. Accordingly, AGC supports S. 758, which helps modernize S. Corporations and provides these businesses with the capital they need to survive. In particular, AGC supports the provisions to:

- increase the number of permitted shareholders
- expand the types of trusts that can own S. Corporation stock
- permit S. Corporations to issue preferred stock
- permit S. Corporations to expand their ownership of subsidiaries
- preserve family-owned businesses

S. Corporations, including many AGC members, are simply asking for a less restrictive business environment in which they can thrive. AGC looks forward to working with the members of the Finance Committee to ensure the adoption of this common-sense S. Corporation reform legislation.

Sincerely,

CHRISTOPHER M. LONG, *Director,*
*Congressional Affairs / Tax and Fiscal Affairs.*

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STATEMENT OF GARY N. BABICK, CPA

*June 19, 1995.*

Hon. ORRIN HATCH,
*Chairman,*
*Subcommittee on Taxation and IRS Oversight,*
*Senate Finance Committee,*
*U.S. Senate,*
*Washington, DC*

Dear Mr. Chairman: As a Certified Public Accountant (CPA) who works with many types of businesses that are designated as S Corporations, I wanted to bring a clarification issue to your attention as your subcommittee begins hearings on your legislation (S 758) to reform the Internal Revenue Code governing S-Corporations.

First, it should be noted that reform legislation overall is desperately needed and S 758 does an outstanding job of solving many of the more serious problems faced by family businesses with respect to S Corporations. Therefore, although I wholeheartedly support passage of S 758, it is requested that your subcommittee address one minor issue.

In Section 214(c)(5) of the bill the general definition of passive investment income includes gross receipts from royalties, rents, dividends, interest and annuities. Following that provision, there are various exceptions provided in 214(c)(5)(B),(C) and (D).

As currently worded there is no distinction made in the statute between true passive rents (such as a net lease arrangement) and a bonafide operating business that receives a significant amount of revenue from rental operations. It seems illogical to "punish" an operating business and treat such a corporation the same as a corporation receiving nonoperating or "true" passive investment income.

The general rule in the statute regarding rents should be clarified or an exception should be created that would remove rents from the passive category if a certain percentage of gross receipts from rents exceeds 40-50 percent of the total corporate gross receipts for the year or if significant services are rendered or substantial costs are incurred by the corporation in operating the rental business.

Thank you for your time and consideration of my comments. Again, please know that I appreciate your efforts to improve this area of taxation and wish you luck in seeing this very important legislation enacted.

Sincerely,

GARY N. BABICK, *CPA.*

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STATEMENT OF THE BUREAU OF WHOLESALE SALES REPRESENTATIVES

(SUBMITTED BY MICHAEL A. WOLYN, EXECUTIVE DIRECTOR)

Mr. Chairman, honorable members of the Committee, I appreciate the opportunity to submit this statement in support of legislation to reform the rules for deducting the expenses associated with maintenance of home offices. The Bureau of Wholesale Sales Representatives is a trade association representing the interests of more than 11,000 independent sales representatives in the apparel, home furnishings, and boot and shoe industries.

Our members are sales representatives who represent the lines of several different manufacturers. They serve as the conduit between manufacturer and retailer. They are paid on a commission basis, and pay all of their business expenses out of pocket. The independent sales representative has been shown time and again to be the most efficient means of moving goods to market.

In the apparel industry, as in many others, sales representatives typically meet with customers (retail store owners or buyers) outside of their offices. These meetings often take place at regional trade shows, at the retail outlet, or over a business meal. The sales representative, who typically represents the lines of several different apparel manufacturers, is provided no office space by those companies, and so frequently establishes an office in the home.

This home office is clearly essential to the management and administration of the business. In the home office, the sales representative: develops and executes marketing plans for his or her various lines; sets appointments with accounts via mail, fax or telephone; performs the substantial recordkeeping function required to track up to 20 different lines of merchandise and hundreds of retail accounts; submits orders obtained to the manufacturer via fax or mail; and records and maintains the voluminous records necessary to comply with federal, state and local tax reporting requirements.

In addition to office space, the sales representative must store product samples, the tools of his or her trade. Currently, one who stores inventory is provided a deduction for the space dedicated to doing so, but space devoted to sample storage is not deductible. We are not talking here about a couple of brief cases; the typical apparel sales representative devotes an entire room to sample storage.

The Supreme Court's January, 1993 ruling in *Commissioner of the IRS v. Soliman* established standards for deducting home office expenses that are so narrow as to effectively eliminate the deduction for most of these independent business persons. In Soliman, the Court interpreted the existing statute in a way that was never intended by Congress and established two new and damaging requirements: (1) that the user must meet with customers in the home office; and (2) that the home office must be the site of performance of the principal business function. It is clear that, while sales representatives' uses of the home office are legitimate and necessary business functions, they may not qualify the home office as deductible under these strict guidelines due to the fact that most sales representatives meet with their customers in places other than their offices.

The House of Representatives has already acted to restore an important measure of fairness to the Tax Code by redefining the home office deduction. During that debate, two Bureau members testified as to the legitimacy of the home office as a business expense. Bureau Secretary Sandi Hanlon, a sales representative residing in Pittsburgh, told that House Small Business Committee that:

"All of my appointments are made in my home office. These appointments yield at least 80 percent of my business. My samples are stored in my garage, which required the addition of a second security system. None of the companies I represent provides or contributes in any way to the support of my office. Those companies, by the way, are located in Atlanta, Los Angeles, New York City, New Jersey, and Florida."

Before the House Committee on Ways and Means, Bureau Treasurer Tom Diedrich, a sales representative out of Minneapolis, reported that:

"Though important, the personal presentation is only one element of selling, and it is not THE definitive close to the large majority of my sales. More critical and often more productive is the pitch-and-shovel work done on the telephone, fax machine, or through the mail. This is why my office is so vital to my business. It is the nerve center, base of operations. Of course, like any small business, I must maintain massive volumes of records in order to operate efficiently and to meet federal, state and local tax reporting requirements. My office, whether it's in an apparel mart or at home, is essential to successfully managing my business."

The solution to solving the home office deduction problem for Bureau members requires legislative action. The suitable solution for independent sales representatives should include generic language to permit active and ongoing small businesses to take a home office deduction, as well as language to resolve the issue of storage of product samples. The solution should also instruct the IRS and the courts to reject using numerical tests as the basis for determining the importance of the home office as the principal place of business.

H.R. 1215, as passed by the House of Representatives, would provide such a solution. In the Senate, S. 327, as introduced by Senator Hatch and currently cosponsored by 12 Senators, is a viable vehicle for reform.

On behalf of the 11,000 independent sales representative that the Bureau represents, I respectfully urge the Committee to acknowledge the damage done by the Supreme Court ruling in Soliman, to embrace the language of S. 327 as a fair and effective means of addressing the current inequity, and to act swiftly and decisively to restore home office deductions for home-based businesses that have no other office space provided and for whom the use of the home office is essential. We would also suggest that the Committee consider clarifying report language, that would leave no doubt as to the intent of this body in respect to the impact of this legislation on independent sales representatives.

I thank the Chairman and the Committee for taking our concerns into consideration during their deliberations. I am available at any time to answer questions the Committee may have regarding sales representatives' use of home offices, and would welcome the opportunity to do so.

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## STATEMENT OF COOPERS & LYBRAND L.L.P.

Chairman Hatch and members of the Subcommittee: Coopers & Lybrand appreciates this opportunity to submit a written statement on behalf of the firm and certain of our clients regarding the mileage clarification in S. 327. We commend the Committee for addressing this important concern.

Clarification of the effect of S. 327 on the business mileage deduction is an extremely important issue for salespeople, particularly those whose sale regions cover rural areas. Current tax law is unclear and the IRS position is frequently perceived as unfair in its distinction between "personal commuting expenses" and deductible business mileage. Two identical business trips can be deductible or non-deductible based on facts that are unrelated to the business purpose of the trip. This discrepancy under current law is viewed as a fundamentally inequitable and indefensible rule in an income-based tax system.

- Under current law, if a salesman drives 100 miles to a sales call and begins and ends each day in a local office provided by the employer, the trip mileage to and from the sales call is deductible. However, if the trip begins and ends in the taxpayer's home driveway, and his or her home office does not qualify for business deductions under Internal Revenue Code Sec. 280A, then the mileage generally does not qualify as deductible business mileage if the trip is inside a so-called "metropolitan area." The concept of a "metropolitan area" is unclear, particularly for the taxpayer who lives in a rural area 400 miles from the nearest urban area and whose business market includes the entire rural area. Taxpayers simply do not accept the explanation that the rules are fair because the sales call is a personal "commuting" expense.

- If the salesperson's trip begins and ends in his or her home driveway, it is deductible if the home office is a structure that is separate from the residence. However, if the home office is under the same roof as the residence and it does not meet the definition of home office in IRC Sec. 280A so that the cost of maintaining it is not deductible, the mileage is generally treated as non-deductible personal commuting. The salesperson can still make the trip deductible, however, by making interim sales calls near home on the way to and from the long distance drive. This arrangement is frequently used by taxpayers to qualify for a business deduction for mileage.

For those taxpayers whose home office is very modest, the deduction allowed for the wear and tear on an automobile and gasoline expenses incurred while traveling to customers is often the preeminent taxpayer concern. Questions about the mileage element were raised during the February 1, 1995 House Ways & Means Committee hearing on H.R. 1215, and IRS Revenue Ruling 94-47 was cited in the House Committee Report[1] to clarify that the deductibility of mileage would be allowed as a result of any modification to IRC Section 280A. We understand that the Joint Committee on Taxation revenue estimate for the modification to IRC Section 280A (as approved by the House) includes the revenue changes relating to business mileage deductibility and, apparently, the revenue associated with the mileage element of the proposal is minor. It is understandable why the revenue estimate for the mileage element was small; taxpayers have already rearranged their business practices to qualify for the deduction to the greatest extent possible.

Witnesses before the Senate Finance Committee June 19, noted a very particular concern with whether the proposed change to IRC Section 280A would allow a taxpayer to deduct regular daily commutes from a home office to a downtown office. Modifications to clarify the treatment of regular daily commutes to one or two regular places of business would certainly seem to be reasonable. However, your usual care as to how you express the congressional intent is needed so as not to unfairly impact salespeople. We believe the following clarifying report language would be viewed as fair and understandable:

> If a taxpayer's home office qualifies as a principal place of business, then the types of business expenses allowed would include a portion of the cost of utilities, insurance, home repairs, security systems, depreciation, and daily transportation expenses between the taxpayer's home office and other work locations in the same trade or business (excluding routine daily commutes to another local office of the taxpayer).

The many salespeople and independent construction contractors who do not have a separate office provided by an employer and who travel to many different sales calls and job sites are relying on this legislation to ensure that their business mileage be treated fairly.

If we can provide any further information, please contact John R. Harman III or Sam Starr at (202) 822-4000.

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## STATEMENT OF THE COOPERS & LYBRAND L.L.P. AND THE COALITION ON S CORPORATION REFORM

Chairman Hatch and members of the Subcommittee—Coopers & Lybrand appreciates this opportunity to submit written testimony on behalf of the Firm and certain of our clients in support of tax reform for S corporations, with special emphasis on the S corporation reform legislation that Chairman Hatch and Senator Pryor have introduced this Congress.

Our purpose in preparing testimony for this hearing is to communicate to Congress how current tax rules seriously restrict the planning and structuring capabilities of existing S corporations. Today, businesses operating as S corporations are limited by tax rules that hinder their growth and ability to obtain financing. S corporation tax laws are fairly complex and contain traps that reduce the benefits of S corporation status. In addition, current law impedes the ability of S corporations to compete both on a domestic and international market level.

Concern over this situation has grown, particularly since an increasing number of corporations have adopted the S corporation format. In 1993, the last year for which statistics are available, slightly over 46 percent of corporate tax returns, or nearly 1.9 million returns, were filed by S corporations. While some may argue that limited liability company (LLC) status is an easy solution to S corporation-related problems, this does not address the fact that 1.9 million *existing* S corporations remain mired in complex, archaic tax rules that have not kept up with today's busi-

[1] H. Rep. 104-84, p.60.

ness environment. Moreover, it is not financially feasible for many S corporations to convert to LLC status, since they would be required to pay tax on gain on appreciated assets upon conversion to LLC status.

BACKGROUND

S corporation laws were first enacted in 1958. They were substantially revised by the Subchapter S Revision Act of 1982, which simplified considerably the taxation of S corporations. Still, S corporations did not become truly popular until 1986, when Congress, for the first time since 1913, inverted the tax rates so that individuals were subject to a lower tax rate (28%) than corporations (34%).

Many S corporations were formed at this time to combine the advantages of the pass-through of income and losses at the lower individual tax rates, and the limited liability of the corporate form. Although the marginal tax rates were reinverted by the passage of the 1993 tax act (individuals now pay a maximum 39.6% tax rate, while corporations pay a top rate of 35%), it is still practical for most S corporations to keep their S status to avoid the double tax imposed on regular corporate earnings. Further, there are significant tax costs to convert into S corporation status. A built-in gains tax applies at the corporate level when a newly converted S corporation disposes of appreciated assets held during existence as a regular corporation. This tax taint stays with these assets for ten years after the conversion. This built-in gains tax and the higher individual marginal tax rates would dampen the possible conversions of regular corporations to S corporation status when this legislation is enacted into law.

CURRENT RESTRICTIONS ON S CORPORATIONS

Despite streamlining over the years, the S corporation rules remain overly restrictive for many small businesses. The existing S corporation rules do not reflect the practical considerations of doing business in today's complicated and often sophisticated world. The small business community and the tax professionals who serve it have long contended that current rules put S corporations at an unfair disadvantage compared to regular corporations, partnerships and limited liability companies.

For example, S corporations are limited to 35 shareholders, none of whom can be either partnerships, other corporations or non-resident aliens. Tax-exempt organizations and certain trusts are not eligible to be S corporation shareholders. S corporations may not issue preferred stock or own more than 80 percent of another corporation's stock. Shareholder-employees of S corporations are taxed on certain tax favored fringe benefits. C corporations enjoy an enhanced charitable contribution benefit to which S corporations are not entitled. There should be no reason why S corporations should not be granted the same charitable giving benefits.

Additionally, S corporation status would be lost if one of the eligibility rules is violated and earnings would then be subject to a double tax. Because the rules are somewhat arcane, many small businesses may not even know the pitfalls they should guard against to sustain S corporation status, and may unwittingly violate the S corporation rules.

S CORPORATION TAX REFORM

The current effort to bring the S corporation rules in line with the complexities of modern small business operations and to level the playing field between S corporations, regular corporations, partnerships and LLCs arose when the American Institute of Certified Public Accountants (AICPA) and members of the American Bar Association's (ABA) S Corporation Committee joined with the U.S. Chamber of Commerce in 1992 to draft a package of proposed legislative changes to the S corporation rules. We are delighted that Senator Pryor, a long-time advocate of small business, along with Chairman Hatch have introduced S. 758, the S Corporation Reform Act of 1995. In the House of Representatives, House Ways & Means Committee members E. Clay Shaw (R-FL) and Robert Matsui (D-CA) have indicated that they will introduce companion legislation in that chamber.

During the 103rd Congress, S corporation reform legislation enjoyed strong bipartisan support in both the Senate and the House of Representatives; the health care reform debate, however, effectively kept the 103rd Congress from acting on other important initiatives. We urge the members of the 104th Congress to work toward the enactment of the S corporation legislation this year.

This legislation represents the greatest change to the tax treatment of S corporations in over a decade and would achieve a number of major goals including: improving the ability of S corporations to obtain financing; removing traps for unwary S corporations; making S corporations easier to pass from generation to generation, thus preserving the ability of family-owned businesses to use the S corporation for-

mat; and removing certain tax barriers that currently impede the ability of S corporations to compete with regular corporations and partnerships. By removing these artificial barriers, S. 758 would ensure S corporations have fewer constraints on how to conduct normal day-to-day business transactions. This increased efficiency eventually could translate into creation of additional jobs and boost the economy.

One of the most important additions to this year's bill is the provision that would permit S corporations to own both C corporation and S corporation subsidiaries. This change would increase flexibility because an S corporation and its wholly-owned subsidiaries would be treated as one corporation and would file one tax return. Currently, if an S corporation owner wishes to start a new business but does not want to subject existing business assets to the liability exposures of the new venture, the new business must be structured as a sister S corporation rather than as a subsidiary. Not only would the proposed legislation allow S corporations to own regular corporate subsidiaries, but it also would permit wholly-owned corporate subsidiaries to be treated as a branch or division of the parent—thus as one pass-through entity. This proposal offers the parent flexibility in structuring corporate operations without risking termination of S status.

SUGGESTED ADDITIONS

In addition to expressing our strong support for the legislation, we would like to suggest that the sponsors of this legislation consider two additional provisions to the bill. First, the legislation should include a provision that would allow S corporations to issue convertible preferred stock. In the 1990's, small businesses can benefit from venture capital for their financing needs. Nevertheless S corporations, unlike regular corporations and partnerships, are prohibited from issuing the preferred stock interests necessary to attract venture capital. This rule exists probably because such financing was not common when the prohibition on multiple classes of stock for S corporations was enacted. Permitting S corporations to issue convertible preferred stock would enable small businesses to have access to start-up and growth capital by permitting them to issue one of the same financial instruments currently used by C corporations. We are told that this change is essential for venture capitalists to invest in S corporations.

Second, we support increasing the number of permitted S corporation shareholders from 35 to 75, or 100. In its current form, S. 758 contains a provision increasing this number to 50 and adopts favorable family attribution rules. These are worthy changes but unfortunately do not fully address situations where S corporation shareholders representing separate families wish to leave their interests to heirs. Since there appears to be no magic or strong policy rationale for limiting the number to 50, we would suggest that this number be increased to 75 or 100.

COMMENTS ON EXISTING PROVISIONS

*S Corporations Permitted To Hold Both C and S Corporation Subsidiaries.* The legislation would repeal the current rule that disallows an S corporation from being a member of an affiliated group of corporations, thus enabling an S corporation to own up to 100 percent of a C corporation's stock. It does preclude, however, an S corporation from being included in a group filing a consolidated tax return. In addition, S corporations would be permitted to own wholly-owned S corporation subsidiaries. Thus, a parent S corporation and its wholly-owned subsidiary would be treated as one corporation and would file one tax return. This provision offers tremendous structuring flexibility to existing S corporations by allowing them to put operations into wholly-owned subsidiaries and be treated as one S corporation.

*Increase the Number of Permitted S Corporation Shareholders.* The legislation would increase the maximum number of shareholders in an S corporation from 35 to 50. Additionally, one family unit per S corporation consisting of no more than seven generations would be treated as a single shareholder, allowing an S corporation to have one family unit and 49 other unrelated individuals as shareholders. As noted above, we would recommend increasing the number of shareholders to 75 or 100.

*Allow Exempt Organizations as Shareholders.* A new source of financing would be provided to S corporations by allowing certain exempt organizations including pensions, profit sharing plans, and employee stock ownership plans (ESOPs) to acquire S corporation stock. S corporation income that flows through to these organizations would be treated as unrelated business income (UBI) to the organization or entity. In addition, charities would be allowed as shareholders of an S corporation for purposes of allowing more flexibility in estate planning and charitable giving.

*Expand Eligible Trust Rules.* Current law eligible trust rules are just too restrictive. The legislation appropriately proposes to expand the types of trusts allowed to

hold S corporation stock. Accumulating and sprinkling trusts, common estate planning techniques, would be eligible shareholders. Each potential current beneficiary of the trust would be counted as a shareholder under the counting conventions of the maximum number of shareholder rules. In a situation where there are no potential current beneficiaries, the trust would be treated as a shareholder. For taxation purposes, the portion of the trust consisting of S corporation stock would be treated as a separate taxpayer and would pay tax at the highest individual tax rate.

*Allow Nonresident Aliens as Shareholders.* This provision would provide the opportunity for nonresident aliens to invest in domestic S corporations and S corporations to operate abroad with a foreign shareholder by allowing nonresident aliens (individuals only) to own S corporation stock. This provision would give S corporations access to another important source of capital. Any effectively-connected U.S. income allocable to the nonresident alien would be subject to the withholding rules that currently apply to foreign partners in a partnership to assure that U.S. revenues are not deflected. This provision would make it much easier for S corporations to attract foreign investors, as well as expand operations outside the United States. The legislation's withholding requirement will assure that non-resident investors pay U.S. tax on their S corporation earnings.

*Allow the Issuance of Preferred Stock.* An S corporation would be allowed to issue certain preferred stock. Generally, the preferred stock would not be convertible and would not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock. Payments to owners of the preferred stock would be deemed as interest rather than a dividend and would provide an interest deduction to the S corporation. This provision would afford S corporations and their shareholders more flexibility in estate planning and in capitalizing the S corporation itself. Unfortunately, the legislation is too restrictive if S corporations are to access venture capital. Attracting venture capital investment requires that an S corporation be able to offer venture capitalists an "up" side in the corporation's appreciation. As noted above, to make venture capital accessible to S corporations, convertible preferred stock is needed.

*Financial Institutions Permitted to Hold Safe Harbor Debt.* An S corporation is not considered to have more than one class of stock if outstanding debt obligations to shareholders meet the "straight debt" safe harbor. Currently, the safe harbor provides that straight debt cannot be convertible into stock. However, the legislation would permit a convertibility provision so long as that provision is the same as one that could have been obtained by a person not related to the S corporation or S corporation shareholders. Additionally, the straight debt safe harbor would be amended to allow creditors who are persons actively and regularly engaged in the business of lending money to hold such debentures. Permitting S corporations to offer different interests to outside investors is another feature designed to provide flexibility to better attract capital.

*Charitable Contributions of Inventory.* This provision would allow the same deduction for charitable contributions of inventory and scientific property used to care for the ill, needy or infants for subchapter S as for subchapter C corporations. In addition, S corporations are no longer disqualified from making "qualified research contributions" (charitable contributions of inventory property to educational institutions or scientific research organizations) for use in research or experimentation. The S corporation's shareholders would also be permitted to increase the basis of their stock by the excess of deductions for charitable contributions over the basis of the property contributed by the S corporation.

*Eliminate Rule Taxing Certain Fringe Benefits of S Corporation Stockholder-Employees.* The current rule that limits the ability of "more-than-two-percent" S corporation shareholder-employees to exclude certain fringe benefits from wages would be repealed for benefits other than health insurance. Under the bill, fringe benefits such as group-term life insurance would become excludable from wages for these shareholders. However, health care benefits would remain taxable.

*Distributions by S Corporations During a Loss Year.* Basis adjustments for distributions made by an S corporation during a taxable year would be taken into account before applying the loss limitation for the year. This would result in distributions during the year reducing adjusted stock basis for purposes of determining the tax status of the distributions made during that year before determining the allowable loss for the year. A similar concept would apply in computing adjustments to the accumulated adjustments account.

*S Corporations as Shareholders in C Corporations.* The current rule treating an S corporation as an individual in its status as a shareholder of another corporation would be repealed, permitting IRC Section 332 liquidations and IRC Section 338 elections. These changes would confirm an S corporation's ability to participate in

tax-free structuring transactions, and are important for flexibility in structuring business operations.

*Curing Certain Invalid Elections.* The legislation would provide the IRS with the authority to extend its current automatic waiver procedure for inadvertent terminations due to defective elections. Additionally, the IRS would be allowed to treat a late Subchapter S election as timely if the Service determines that there was reasonable cause for the failure to make the election timely. The provision would apply to taxable years beginning after December 31, 1982. This is an important provision which allows taxpayers to recover from inadvertent traps in complying with the complicated S corporation eligibility rules.

*Certain Financial Institutions Defined as Eligible Corporations.* Under the bill, financial institutions that do not use the reserve method of accounting for bad debts would be eligible to elect S corporation status.

*Repeal Passive Income as a Termination Event.* This provision would repeal the current rule that terminates S corporation status for certain 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. S. 758 would not repeal the rule that imposes a tax on those corporations possessing excess net passive investment income. It would liberalize this tax by raising the threshold triggering the tax to 50% of passive receipts from passive income sources rather the present law 25% threshold. The rate of the passive income tax would be increased if applicable.

*Treatment of Liquidation Losses.* Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation.

*Repeal Restrictions on Qualified Loans.* The legislation provides that subchapter-S shareholder-employees no longer will be deemed to be owner-employees under the rules prohibiting loans to owner-employees from qualified retirement plans.

*Elimination of Pre-1983 Earnings.* S corporation earnings and profits attributable to taxable years prior to 1983 would be eliminated. This change will simplify distributions for those S corporations in existence prior to 1983.

*Other Technical Changes.* Other technical changes made to current S corporation rules by S. 758 include expanding the post-death qualification for certain trusts; modifying shareholder election to close the S corporation's tax years when a shareholder terminates interest; expanding the post-termination transition period; providing a consent dividend for AAA bypass elections; and allowing at-risk suspended losses to be utilized during the post-termination transition period.

Coopers & Lybrand L.L.P. would like to add its voice to that of our clients in support for the legislation. We are joined by many in the business community and on Capitol Hill. We cannot stress enough the need for timely S corporation tax reform in light of the unfair obstacles that face existing S corporations through today's tax code. As the budget reconciliation process seems to be the most logical vehicle to carry S corporation reform to enactment, we strongly advocate adding the S corporation reform provisions to the final budget reconciliation bill, or another tax vehicle this year. We thank you for giving us the opportunity to present our views on this important subject. If we can be of any assistance to you in your consideration of this legislation, please feel free to contact National Tax Partners Sam Starr at (202) 822-4279 or Pamela Pecarich at (202) 822-4239.

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## Statement of Doeren Mayhew & Co., P.C.

(SUBMITTED BY MICHAEL J. BERRY)

My name is Michael J. Berry and I am a tax director and part owner of Doeren Mayhew & Co., P.C., a regional public accounting firm, located in Troy, Michigan. I appreciate the opportunity to submit this written testimony in support of S. 758. I am testifying on behalf of Doeren Mayhew, an S corporation, as well as on behalf of the coalition called the S Corporation Reform Project, of which I am a member of the Advisory Committee. In addition, I am testifying on behalf of the many S corporation clients that our public accounting firm represents. As you can see, my interest in this legislation stems not only from my direct ownership interest in an S corporation, but also from my responsibilities as a tax advisor to our S corporation clients. I see first hand the problems faced by S corporation owners which are caused by the many restrictions placed on them as compared to their C corporation counterparts. I am convinced that S. 758 would help modernize Subchapter S of the Internal Revenue Code to make it more compatible with today's business environment by removing compliance problems, unnecessary impediments to capital forma-

tion, and technical complexities facing S corporations. I am pleased to testify on behalf of this important legislation.

Following is a summary of the improvements that would be made to the S corporation business environment should this legislation be passed. I can assure you that each of the provisions of S. 758 specifically address real life problems and complexities that I have encountered as a tax advisor to S corporation clients of our firm.

PRESERVING FAMILY-OWNED BUSINESSES

*1. Count all Members of a Single Family as One Shareholder*

This provision would permit an election to be made with the consent of all shareholders to count family members, that are not more than six generations removed from a common ancestor, as one shareholder for purposes of the S corporation limitation on the number of shareholders. This election is available to only one family in any corporation. This provision will permit businesses owned by large families to be S corporations and still enable employees or others to own stock in the corporation.

*2. Permit Certain Complex Trusts that Qualify as "Electing Small Business Trusts" to Own S Corporation Stock*

My experience has been that proper estate planning is very much hindered by the limited availability of trusts as S corporation shareholders. This provision would permit S corporation shareholders to achieve many estate planning goals not currently available. Specifically, this provision would permit S corporation shareholders to utilize complex trusts with multiple beneficiaries and permit the trustee to have discretion in making distributions among the beneficiaries. The availability of this kind of trust is necessary for a variety of legal reasons where there is more than one trust beneficiary. This flexibility is consistent with a major underlying purpose of the S corporation—to provide a vehicle for family-owned corporations. Succession of the business to future generations would be simplified by this flexibility.

INCREASING SOURCES OF CAPITAL FORMATION

*1. Permit S Corporations to Issue Preferred Stock*

Currently, S corporations may not issue more than one class of stock. By permitting S corporations to issue preferred stock, the bill increases access to capital from investors who prefer to be sheltered from the direct risk associated with holding common stock. The provision also facilitates family succession by permitting the older generation of shareholders to relinquish control of the corporation but still maintain an equity interest. A distribution made with respect to preferred stock would be treated as interest income to the preferred shareholder and as deductible expense to the S corporation.

*2. Permit Convertible Debt*

The bill permits 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. Currently, utilization of a conversion feature for debt may result in termination of the S election. The provision will also permit the debt to be held not only by qualified shareholders, but also by a person who is actively and regularly engaged in the business of lending money. The current law provision, which does not provide a safe harbor for debt that can be converted into stock, unnecessarily hinders the ability of an S corporation to raise investment capital.

INCREASING THE AVAILABILITY OF S CORPORATION STATUS

*1. Increase the Number of Permitted Shareholders from 35 to 50*

Currently, a corporation is not eligible to be an S corporation if it has more than 35 shareholders. This limitation can easily cause problems for family businesses which are run by either more than one family or by several generations of a single family. Increasing the number of permitted shareholders to 50 will make S corporation status available to more closely-held businesses, allowing them the benefits of limited liability. Further, increasing the number of permitted shareholders will enable S corporations to raise more capital.

*2. Permit Tax-Exempt Organizations to Own S Corporation Stock (Including ESOP's)*

This provision would permit charities and pension plans to be eligible shareholders of an S corporation, thereby increasing S corporation's access to additional cap-

ital markets. Specifically, an S corporation would be able to establish an employee stock ownership plan (ESOP) and would have access to capital from charitable organizations and pension funds. By way of example, one of our firm's most successful clients has desired to permit its employees to participate and share in its success through an ESOP plan. It has been very difficult to explain to this client that current tax law does not permit such benevolence.

*3. Allow Non-resident Alien Shareholders to Own S Corporation Stock*

The bill would permit non-resident aliens to be eligible shareholders of an S corporation. This increases an S corporation's access to capital. It also enhances an S corporation's ability to expand into international markets by providing an opportunity to offer an equity interest to non-resident aliens who could help expand their business in other countries. Collection of tax from non-resident alien shareholders is ensured by subjecting these shareholders to U.S. withholding tax on S corporation income.

*4. Permit an S Corporation to Own Subsidiaries*

Currently, S corporations may not own more than 79 percent of a C corporation. The bill will allow S corporations to have C corporation subsidiaries, by permitting them to own 80 percent or more of a C corporation's stock. This provision enhances an S corporation's ability to achieve important non-tax objectives in structuring their operations, such as limiting their liability and eliminating complications in dealing with banks and other financial institutions. For example, it is often preferable to shield the assets of one business component from the risks of another. Utilization of subsidiaries achieves this goal. Currently, S corporations must engage in much more complicated and expensive business structuring in order to protect the assets of one business from the risks of another. In addition, an S corporation would be permitted to own wholly-owned S corporation subsidiaries. By permitting an S corporation to serve as a holding company for various operating S corporations, management of the group would be simplified. For example, the holding company could serve as a common paymaster and facilitate obtaining financing for the group.

REMOVING TRAPS FOR THE UNWARY

*1. Permit the Secretary of Treasury to Validate Invalid Elections and Permit Late Elections*

A considerable amount of my time as a tax advisor to S corporations is spent on educating them on what they can and cannot do in order to prevent an inadvertent termination of the S election. Some limited relief is currently available in the case of an inadvertent termination event. However, current law does not permit the IRS to validate invalid elections or to extend the period of time for making the S election.

The S corporation election is made by timely filing Form 2553 with all the necessary information and consents by the shareholders. In some cases, with the lack of sophisticated tax advisors, the S election is not perfected and it is subsequently determined to be invalid.

This provision permits the IRS to retroactively validate an invalid S corporation election in cases where the corporation inadvertently failed to meet the definition of a small business corporation or to obtain the required shareholder consents. The bill sets forth the criteria under which the IRS should validate such elections. The bill also provides for an automatic waiver procedure for certain inadvertent terminations. In addition, the bill provides that if a corporation fails to make a timely S election and the Secretary determines that there was reasonable cause for the failure to make such election, the Secretary may treat the election as timely made.

*2. Repeal Excessive Passive Income as a Termination Event*

Under existing law, if more than 25 percent of an S corporation's gross receipts is passive investment income, a corporate level tax is imposed at the highest corporate tax rate on the excess passive income. In addition, if passive investment income exceeds 25 percent of gross receipts for 3 consecutive years, the S election is terminated. The bill would increase the threshold for taxing excess passive income from 25 percent to 50 percent. The provision would also provide that an S corporation would not lose its S corporation status if it has excess passive income for three consecutive years. Instead, the corporate level tax rate applied to the excess passive income would increase by 10 percent for each successive year, reaching a maximum 50 percent increase in the eighth year. The provision also makes it clear that items of income connected with an S corporation's trade or business will not be considered passive income.

*3. Require Only Consent of Affected Shareholders to Interim Closing of the Books on Termination of Shareholder Interest*

Under current law, if a shareholder terminates his/her interest in an S corporation during a tax year, and if *all* persons who were shareholders during that year consent, the tax year is hypothetically closed as of the termination date and is treated as if it consisted of two tax years, the first of which ends on the date the shareholder's interest terminates. The bill would eliminate the requirement that all shareholders consent. Instead, only the "affected shareholders" would have to consent to the closing. Affected shareholders are the shareholders whose interest is terminated and all shareholders to whom that shareholder transferred shares during the year. In the case of a redemption, all shareholders during the year would be affected shareholders.

*4. Permit Tax-Free Distributions in Loss Years*

Under current law, stock basis in an S corporation is first reduced by current year losses before consideration is given to current year distributions. This means that the ultimate treatment of a distribution as tax-free or taxable is not known for certain until the end of the taxable year. I have experienced situations in my practice where clients have made distributions of prior years earnings on the assumption that they were tax-free only to be surprised that an unexpected loss for the current year recharacterized the distributions as a taxable dividend from Subchapter C earnings and profits.

The bill remedies this situation by changing the ordering rules. It would reduce stock basis first by distributions and then by operating losses. Taxpayers could then make distributions with certainty as to their tax treatment.

*5. Permit Deemed Dividend to Avoid Passive Investment Income Tax*

The passive investment income tax only applies if an S corporation has both passive investment income and accumulated earnings from years when it was a regular C corporation. One way to avoid the passive investment income tax is for the corporation to distribute its accumulated C corporation earnings. Currently, this distribution must be in the form of cash or property and must be made within the taxable year.

The bill would permit an S corporation to make a hypothetical distribution of C corporation earnings and profits without actually distributed cash or property. S corporations without adequate cash reserves would, therefore, be permitted to avoid the passive investment income tax. This change would also assist S corporations with loan agreements that prohibit distributions beyond agreed upon amounts.

*6. Preservation of One Level of Tax on Liquidation of S Corporations*

When an S corporation is liquidated, double taxation may result under current law because of a mismatch of ordinary income. Under the bill, any loss on the liquidating distribution would be treated as an ordinary loss to the extent the corporate-level income was ordinary, and could thus offset the ordinary income passed through from the corporation.

CONCLUSION

S. 758 provides much needed improvement to the rules governing S corporations. About 50 percent of our corporate client base have elected S corporation status. They are spread across the industrial base including service organizations, retail and wholesale trades, construction, and manufacturing entities. One thing they have in common is that they tend to be family owned businesses. It is a well known fact that a very significant portion of job growth in this country comes from so-called "small business." This legislation would provide much needed reform to the rules governing an integral part of the U.S. economy. Thank you for the opportunity to testify in support of this legislation.

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STATEMENT OF THE HOME OFFICE ASSOCIATION OF AMERICA

Chairman Hatch, Senator Bradley, and Members of the Subcommittee on Taxation and IRS Oversight, my name is Richard Ekstract. I am Chairman of the Home Office Association of America ("HOAA"), an organization dedicated to serving the needs of individuals whose offices are in their homes. I appreciate the opportunity to submit testimony on an issue of vital importance to HOAA: the home office expense deduction.

BACKGROUND ON HOME OFFICE EXPENSE DEDUCTION ISSUE

Up until enactment of the 1976 Tax Reform Act, taxpayers were able to take liberal advantage of home office deductions for most types of work conducted at their personal residences, either as an ordinary and necessary business expense under tax code section 162 or as an expense for the production of income under section 212. In response to perceived abuses of the deduction, Congress enacted section 280A, which sets forth rules and limits on the deductibility of expenses attributable to the business use of homes for individuals and S Corporations.

These rules and limitations no longer reflect the realities of how individuals work in today's world. Section 280A states that no home office deductions are allowed unless the deduction meets specific, and in our view overly complex, statutory requirements. It is virtually impossible for a large number of home office workers to qualify under these rules, and those that qualify cannot be sure that they do.

The rules state that the portion of the home that is used for business must be used exclusively on a regular basis,[1] and in only one of the three following ways: (1) as the principal place of business for any trade or business;[2] as a place normally used by clients, patients, or customers;[3] or in connection with the taxpayer's trade or business if the taxpayer is using a separate structure unattached to the personal residence.[4] Of these additional requirements, we have found that defining a taxpayer's "principal place of business" is the most difficult, and the various tests which have been formulated by the courts cannot achieve equitable results.

SUPREME COURT RESTRICTIONS ARE NOT REASONABLE

In *Soliman v. Commissioner,*[5] the Supreme Court exacerbated the statute's already confusing scheme. In that case, the Court attempted to address the appropriate factors a taxpayer must use in determining whether a home office is his or her "principal place of business." The taxpayer in Soliman was an anesthesiologist who was employed by three hospitals, but who maintained a home office as a principal place of business used exclusively two to three hours a day for contacting patients and surgeons, and for performing related activities.

Even though the hospitals provided no office space to the taxpayer in *Soliman,* the Supreme Court reversed the lower court decisions which had allowed the deduction.[6] The Court's effort significantly narrowed the scope of the home office deduction by setting up a comparative test for determining whether an individual's home office is that person's principal place of business.[7]

The comparative test does not work. The Court's two primary factors—(1) the relative importance of the activities performed at each business location, and (2) the amount of time the taxpayer spends at each place of business—are too vague.[8]

The IRS' subsequent explanation of how it will apply the "relative importance" and "time" tests highlights the complex problems that the normal, unsophisticated home office worker must now confront.[9] Under this ruling, the Service said it will first apply the "relative importance" test, and if this test yields no definitive answer,

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[1] See § 280A(c)(1).

[2] § 280A(c)(1)(A).

[3] § 280A(c)(1)(B).

[4] § 280A(c)(1)(c). Two additional exceptions are provided in the statute which do not require exclusive use of a portion of a residence. A taxpayer in the business of selling products at retail or wholesale may take deductions allocable to space within the residence which is used on a regular basis as a storage unit for inventory of the business. This exception is only available if the residence is the sole fixed location of the business. See § 280A(C)(2). A taxpayer regularly using the residence to provide day care for children, adults over age 65, or mentally or physically disabled persons may qualify for deductions allocable to the day care business. See § 280A(c)(4). Deductions under § 280A are limited to the excess of (1) gross income from the use of the dwelling unit over (2) the deductions allocable to the unit which are allowable without regard to business use. See § 280A(c)(5).

[5] 113 S. Ct. 701 (1993).

[6] 113 S. Ct. at 708.

[7] Id. at 706. The Court rejected both the "focal point" test formerly favored by the Tax Court and the facts and circumstances test subsequently adopted by the Tax Court, which had won approval of the U.S. Court of Appeals for the Fourth Circuit.

[8] Id. In denying the home office deduction, the Supreme Court determined that the taxpayer's treatment of patients at the three hospitals was the "essence of a professional service" and the "most significant event in the professional transaction." The home office activities were regarded as less important to the taxpayer's business than his work at the hospitals. Id. at 708.

[9] Rev. Rul. 94-24, 1994-15 I.R.B. 5. The IRS had previously announced that it will not challenge home office deductions taken for 1991 and earlier tax years if the taxpayer reasonably fell within the scope of previous guidance issued by the IRS. See Notice 93-12, 1993-8 I.R.B. 1. The Service has also withdrawn a portion of proposed regulations under § 280A (issued in 1983) to reflect the Soliman decision. See IA-23-93, 59 Fed. Reg. 26466 (May 20, 1994).

it will look to the "time" test.[10] There is no way for a home office worker to achieve any level of comfort with these rules without expending considerable funds in lawyer or accountant fees.

RESPONSES TO SOLIMAN

We applaud Congress' response to the Soliman decision, as numerous bills were introduced in the 103rd Congress. We are extremely pleased that Chairman Hatch has taken the lead on this issue in the 104th Congress. Senator Hatch introduced legislation (S. 327) clarifying the deduction on February 1, 1995. The legislation has 17 cosponsors, including Subcommittee Members Grassley and D'Amato and full Committee Members Chafee and Baucus. We strongly urge that the provisions of S. 327 be included in the reconciliation bill which the Congress will send to the President later this year.

S. 327 would amend present-law section 280A to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the essential administrative or management activities of the business. As under current law, deductions would be allowed for a home office meeting the aforementioned two-part test only if the office is exclusively used on a regular basis as the place of business by the taxpayer, and in the case of an employee, only if such exclusive use is for the convenience of the employer. S. 327 would also clarify that a deduction of business expenses attributable to home storage space for product samples is also permitted under the law.[11]

CLARIFYING HOME OFFICE EXPENSE DEDUCTION MAKES SENSE FOR THE 1990'S AND BEYOND

The Soliman decision is not in step with commercial practice and economic reality. Home-based businesses have been growing in number and will likely continue to do so for the indefinite future.[12] These businesses create opportunity and jobs.

Many individuals affected by corporate downsizing have responded by creating small businesses operated out of the home. With the advent of fax machines, personal computers, and other telecommunications advances, these entrepreneurs have been able to run businesses out of the home that traditionally required an office setting. The success of many of these businesses has depended on whether or not they could be started up as home-based enterprises. The existence of a tax deduction for home office expenses can make an important difference for these fledgling companies.

Clarifying the home office expense deduction also makes sense from a family perspective. Home-based businesses have become an attractive option for parents who choose to work at home to spend more time with their children or elderly parents. Taxpayers should not be penalized for making such a choice.

CLARIFYING HOME OFFICE EXPENSE DEDUCTION WOULD REPRESENT STRONG STEP TOWARD PROVIDING EQUITABLE TREATMENT TO HOME OFFICE BUSINESSES

Mr. Chairman, a sense of excitement exists when entrepreneurs start up their home office businesses. Many express relief to be free from headaches like commuting, endless meetings, and office politics. They feel that they will be as free to go as far as their abilities will take them. Then, reality sets in. They realize that when it comes to allowing deductions for legitimate business expenses, the Federal Government caters to big business, not to them.

HOAA believes it is unfair and unjustified to premise the right to a business deduction on whether a taxpayer works for a Fortune 500 corporation or for himself

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[10] Rev. Rul. 94-24, 1994-15 I.R.B. 5.

[11] We certainly agree with the Treasury Department that every effort should be made to avoid passing legislation that turns back the clock and creates a level of ambiguity that would result in more disputes between taxpayers and the IRS. Toward that end, we would support additional clarifications that limit the effects of S. 327 to home office expenses. However, we are concerned about Treasury's rather general statements on the need to modify S. 327 to protect against abuses. We would strongly oppose any changes that would deny legitimate home office business owners a deduction for their business expenses.

[12] One 1992 news article reported that approximately 30 million Americans work out of the home. See G. Hall, *Home Based Businesses Create Local Controversies, Gannett News Service (Nov. 10, 1992); see also New Publishers Serve At-Home Workers,* L.A. Times, Feb. 14, 1993, at D10. The number of publications serving the growing number of at-home workers has risen dramatically. At present, there are approximately 50 publications. See id.

or herself out of the home. Such treatment is simply one example of the ways home office business owners are treated as second-class entrepreneurs. Clarifying the deduction for home office expenses would represent a strong step toward providing more equitable treatment to home office businesses.

CONCLUSION

To conclude, I appreciate the opportunity to submit testimony on the importance to HOAA of preserving the home office expense deduction. The Soliman decision is ill-suited to the modern economy. Clarification of the home office expense deduction rules makes sense from both a business and family perspective and would send the right message to home-based business owners.

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STATEMENT OF THE LIBERTY CHECK PRINTERS

(SUBMITTED BY DAVID COPHAM CEO)

My name is David Copham, and I am the founder and Chief Executive Officer of Liberty Check Printers in Mounds View, Minnesota. Thank you for this opportunity to share my company's views about S Corporation Reform, an issue that I believe is critical to my business, thousands of others like mine in the state of Minnesota, and I .9 million more nationwide.

As an S Corporation owner, I believe we need to improve the means by which U.S. entrepreneurs access capital. First, though, I would like to thank the Chairman, Senator David Pryor and this Committee for their efforts to create an environment in which American entrepreneurs like me have the opportunity to build strong and healthy businesses that can provide for their owners and employees. I would also like to thank the 26 other senate cosponsors of S.758, the "S Corporation Reform Act"—a measure that would vastly improve the ability of entrepreneurs to operate, access capital, expand their businesses and continue to contribute to local, state and national economies.

By way of background, Liberty Check Printers manufactures and distributes the checks provided by more than 2,700 credit unions to their members nationwide. This year, Liberty will earn almost $6 million on sales of approximately $42 million. Liberty is organized as an S Corporation because I am the company's principal owner and manager.

Each year for the last five, Liberty has achieved average annual growth rates of 45 percent for sales and 55 percent for net income. We have 330 employees at facilities in five states. We just completed what for us was a major acquisition and are considering additional facilities and acquisitions in the next few years.

If Liberty has done so well, why am I concerned about capital access and formation? The answer, in short, is that current limitations threaten the future of many S Corporations. While those limitations can be terribly unfair and anticompetitive, I would submit that, in large part, they can be overcome by legislative solutions now before the Congress.

RESTRICTED CAPITAL ACCESS

S Corporations are limited by law and practice from access to many types of financing that are both standard and important for every other type of company doing business in the U.S. and world economy.

While there are serious issues restricting access to funds outside the company, my main concern and primary interest and the focus of my testimony today is the restriction of access to funds inside the company—an S Corporation's own employees. While the tremendous growth that Liberty has experienced is largely a result of the hard work of our employees, current law prohibits me from giving these workers a share of the company's gains. I very much want to ensure that those who own my company are committed to its success, as I have been. An employee stock ownership program, or "ESOP," is an ideal way to keep that commitment within my company, to give our workers the opportunity reap the benefits of their work, and to provide a source of capital to our business to help sustain the track record that we have worked so hard to establish.

The current law, however, prohibits S Corporations from establishing ESOPs. I am referring specifically to two prohibitions: one, that S Corporations may not have more than 35 shareholders; and two, that S Corporation stock may not be owned by a trust if the benefits of the trust accrue to multiple persons. The combined effect of these rules is that S Corporations may not create ESOPs for their workers.

Consequently, the workers of S Corporations are deprived of tremendous opportunity to participate in their companies' success and to ensure for their futures,

while S Corporations themselves are denied what is more and more becoming an important new source of reliable capital. At Liberty our goal is to allocate some of the funds earned by our employees' Profit Sharing and 401 K Plans to the ownership of Liberty stock. There is a tremendous amount of support for this among the employees at Liberty. In fact many have also written their representatives giving support for this legislation. In anticipation of passage of this law we already have over $500,000 within our Profit Sharing program which can be used to initially fund the ESOP.

### UNIQUE TAX BURDENS ON CAPITAL

Enhanced capital access for S Corporations is an even more pressing concern when you consider that recent changes in tax rates penalize S Corporations for reinvesting their earnings back into their businesses. S Corporation shareholders pay the taxes on the profits of their businesses—regardless of whether the company distributes or retains its earnings. Like all employees, we owners of S Corporations pay taxes on our take-home wages and distributions. The difference is that we also pay taxes on our pro rata share of whatever funds the company reinvests in the business toward growth.

As you are aware, top-level federal tax rates increased from 33 percent to 39.6 percent—which means the current rate is 16 percent greater than the previous one. As a result, Liberty's taxes rose, too. But Liberty's taxes rose even more than the increase in federal rates: ours went up by 26 percent, largely because we paid taxes on the significant earnings we reinvested.

Some individuals have advocated the alternative structure of a Limited Liability Corporation (LLC) in place of Sub Chapter S Corporations. Certainly that is an option for those companies being formed in the future provided every state approves the concept. However, for those companies like Liberty who already have years of history, the conversion is prohibited by the tremendous tax consequence.

Attached to this statement is an accountant's worksheet indicating just how expensive this change would be for Liberty. As you can see, the total tax to dissolve Liberty and reorganize as an LLC would be almost $7,000,000. We could not afford to pay the tax so the alternative simply doesn't pertain to us. I'd assume we are somewhat typical of successful S Corporations.

### CONCLUSION

The legislation being introduced by Senators Hatch and Pryor, and cosponsored by five additional Members of this Committee would address all of the issues I have raised today. It would open up alternative sources of private capital that are critical to the competitive ability of S Corporations. It would ensure that, in the face of increased demands on S Corporations existing capital base, funds are available to enable continued growth. And it would allow S Corporations to create ESOPs, providing major opportunities for our employees to benefit from their own hard work and determination.

These reforms can make a world of difference to S Corporations' long-term ability to be competitive, to grow, and to continue to fuel American economic growth as we have for many years. I thank the Chairman for taking an active role in examining this most important legislative initiative, and urge this Committee to continue its work to ensure competitive capital access for American S Corporations. Thank you for this opportunity to submit testimony.

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## STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Subcommittee:

We are pleased to present the views of the 186,000 member firms of the National Association of Home Builders (NAHB) on the current proposals relating to the Home Office Deduction and Subchapter S Corporations. At the outset, NAHB would like to express its appreciation to you, Senator Hatch, for your and Senator Pryor's steadfast support of small business and for your leadership in reinstating the tax deduction for home office expenses for many Americans. Although not a part of these hearings, we would also like to thank you for your highly proficient leadership with respect to reducing the taxation of capital gains. NAHB strongly supports S. 327 (the Home Office Deduction Act of 1995) and S. 758 (the S Corporation Reform Act of 1995). Modification of the federal income tax laws pertaining to these issues is of great significance to the many small business firms that make up our membership.

HOME OFFICE DEDUCTION

The construction of a single family home involves about 1,000 hours of on-site labor, and entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades at that site. The 1,000 labor hours may be performed by as many as 100 different workers. most of whom are proprietors or employees of subcontractor firms, whose work schedule must be carefully planned. Under the current law, although the scheduling of the subcontractors, and other related administrative activities, are most significant and essential, a builder/remodeler operating out of a home office would not qualify to deduct his/her legitimate business expenses.

The United States Supreme Court's Soliman decision effectively eliminated the home office deduction for the real estate construction industry. Your proposal would amend the Internal Revenue Code to specifically provide that a home office qualifies as a "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the essential administrative or management activities of the business.

The home building industry is dominated by small firms. many of which use home offices as their primary administrative location for doing business. Eighty percent of NAHB's builder-members construct fewer than 25 homes a year and most of these firms do not maintain a separate office. Many operate out of their homes, making necessary contacts with subcontractors and customers and where, very often, other family members assist in the administrative and clerical duties of the business.

S. 327 will help reduce housing costs by reducing builder/remodeler's costs. Because of the highly competitive nature of the construction business and the number of firms available to perform services, the reinstatement of the home office deduction will translate into lower house prices. For an average builder who constructs 10 homes a year, and uses his home as the center of operation, the savings could be several hundred dollars per home.

SUBCHAPTER S CORPORATIONS

The S Corporation Reform Act (S. 758) would, in part, provide clear and objective rules with respect to preservation of S corporation status and simplification of requirements for qualifying for, and maintaining, subchapter S status. The bill would also raise the maximum number of eligible shareholders from 35 to 50, and preserve family businesses.

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. A builders' organizational structure tends to depend on the size of the business. Two out of three builder firms are organized as corporations. Twenty-five percent of small-volume builders (builders who build less than 25 homes per year) are sole proprietorships, whereas only 8 percent of the medium (25-99 houses per year) and large (over 100 houses per year) volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships. During the last ten years, more builders and remodelers have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

Under the present law, although the IRS may waive the effect of an inadvertent S corporation termination, it does not have the authority to waive the effect of an inadvertent invalid Subchapter S election. We support the S. 758 proposal to remove tax traps for the unwary, by allowing the IRS to also waive the effect of an inadvertent, invalid, or untimely S corporation election. We also agree with the suggestion that your bill include a provision to change the S corporation definition of "passive income" to exclude income earned from the active conduct of a rental real estate trade or business. The current law definition precludes many rental real estate operating companies from electing S corporation status.

Finally, under present law, to qualify as an S corporation; the corporation may not have more than 35 shareholders. NAHB supports the proposal to expand the maximum number of shareholders to 50 and to allow all family members to be treated as one shareholder. This important change would do much towards making federal tax law more favorable to preserving family-owned businesses.

CONCLUSION

For the reasons stated above, the National Association of Home Builders believes that the Home Office Deduction and Subchapter S Corporation proposals would be of great benefit to the home construction and remodeling industry. These proposals would provide much needed tax relief, restore taxpayer fairness for small business owners and stimulate further growth in the economy. We understand that some Members of Congress have suggested cutting back on the tax deduction for home mortgage interest in an effort to reduce the deficit or in exchange for enactment of certain tax proposals, such as reducing capital gains.

While we fully support the tax cut proposals currently being discussed, NAHB would strongly resist any tampering with the mortgage interest deduction, which we maintain is the cornerstone of housing policy and the principal government policy that changed this nation from one of renters to one with 65% home ownership.

Once again Mr. Chairman, NAHB thanks you for this opportunity to present our views. We look forward to working more closely with you and your staff in the coming years.

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STATEMENT OF THE NATIONAL BUSINESS OWNERS ASSOCIATION, INC.

(SUBMITTED BY J. DREW HIATT, EXECUTIVE VICE PRESIDENT DIRECTOR OF GOVERNMENT AFFAIRS)

Mr. Chairman, Senator Bradley, and members of the Committee, my name is Mr. J. Drew Hiatt. I am Executive Vice President and Director of Government Affairs for the National Business Owners Association. We appreciate this opportunity to present our views on S. 758, The S Corporation Reform Act of 1995 and how this legislation will benefit S corporations.

The National Business Owners Association represents an active and expanding small business membership. Our philosophy is based on the belief that a strong and competitive free enterprise economy is essential to foster economic growth, create jobs and opportunity, and ensure prosperity for all Americans. NBOA represents the interests of its members before Congress as well as federal, state, and local government.

We commend you, Mr. Chairman, for your leadership in convening this hearing today to focus on the need for changes to current tax provisions that affect S corporations and to remove obstacles to their continued growth and competitiveness in the marketplace. Your introduction, along with Senator David Pryor, of S. 758, the S Corporation Reform Act of 1995, demonstrates your understanding of the importance of S corporations and their role in the American economy, as well as the challenges facing them. We are grateful to you and your colleagues for your efforts to reform laws governing S corporations and your commitment to assist business owners.

It is estimated that more than 1.6 million businesses operate as S corporations nationwide. These firms are generally family-owned-and-operated businesses or otherwise closely held organizations. Their contributions to job creation and productivity have strengthened the overall economy. The overwhelmingly majority of these firms are small businesses. Small firms, including S corporations, are the powerhouse of our economy. All told, they generate about 40 percent of our gross national product and provide more than half of our goods and services. Small business is the nation's leading employer. Today, six in 10 Americans take home a paycheck from a small firm.

Small business is not only the nation's leading employer, it is also the major provider of new jobs. Over the last five years, small firms have created nine of 10 net new jobs. In fact, according to the U.S. Small Business Administration, they are expected to create more than three-quarters of the 43 million new jobs needed over the next 25 years.

S corporations can make significant contributions to the nation's future job growth needs. But unless the restrictions that impede these firms' ability to grow and expand are removed, the likelihood that they will create—or can create—the new jobs needed in the coming quarter century is not great. The rules that were adopted in 1958, when S corporations were created, and amended in 1982, are not only antiquated but out of touch with the realities of today's marketplace, to say nothing of tomorrow's economy. The operating and capital needs of S corporations have changed and the law must be changed to accommodate the current needs of these firms. If S corporations are to continue to survive, succeed, and prosper well into the 21st century and beyond, now is the time to change the rules—obsolete and ineffective rules—that have governed these businesses for nearly four decades.

Over the years, Congress and the federal government have been slow to remove obstacles confronting small businesses. Every barrier that remains in place, every burden that continues decreases the odds of their survival and success. That's why Congress and the federal government should remove the roadblocks to growth and relieve the burdens that hold back small businesses and deny them opportunities to expand and prosper.

Congress and the federal government should do all they can to support small business owners, particularly owners of small S corporations, recognizing that they have done and do so much for this country. This legislation recognizes the special needs and circumstances of small businesses, and it takes aim at eliminating some of the obstacles facing companies organized as S-corporations. S. 758:

- expands access to capital and the ability to attract investment;
- enables owners to grow and streamline their businesses;
- eases tax and estate planning;
- preserves family-owned businesses and increases family ownership;
- eliminates undesirable tax traps; and,
- simplifies and amends laws governing S corporations.

These changes will remove many of the obstacles S corporation owners have long identified as major hindrances to the growth of their companies. This legislation, if enacted, will go a long way toward improving the overall survival and success prospects of many such firms. Small businesses—particularly small businesses organized as S corporations—hold the key to America's continued economic growth and prosperity.

We appreciate this opportunity to present our views in support of S. 758, The S Corporation Reform Act of 1995. On behalf of our small business members, especially those who own S corporations, we urge the members of this subcommittee to pass this critical reform legislation without delay.

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## Statement of Robinson Transport, Inc.

(SUBMITTED BY KIM ROBINSON, PRESIDENT)

I am President of Robinson Transport, a trucking company in Salina, Utah. I am also a member of the S Corporation Reform Project.

Thank you Chairman Hatch and Senator Pryor for sponsoring this legislation.

My father purchased his first coal truck in 1943. His first truck cost $700. A coal truck and trailer today costs about $200,000. Needless to say, capital requirements are tremendous for our family business to survive. Our company has hauled over 19.7 million tons of coal since its inception. We provide good paying jobs for over 98 people in Sevier County, Utah.. Five years ago we employed 72 people. Our company participated in the longest, largest tonnage coal truck haul in the U.S., possibly the world, that enabled a power plant to continue operating.

S corporation status allowed our company in its earlier years to survive and prosper.

I have read this bill and it would again help us to be more competitive.

Thanks again Senator Hatch and Senator Pryor for supporting this legislation.

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## Statement of the S Corporation Coalition

The S Corporation Coalition is pleased to submit testimony to the Taxation and Oversight Subcommittee in support of S. 758, the "S Corporation Reform Act of 1995" (the "S Corporation Reform Act"). The S Corporation Coalition is a group of companies from across the country representing a wide range of industries that strongly supports the needed reform of the Subchapter S rules that is contained in the S Corporation Reform Act. As explained below, the S Corporation Coalition believes that the S Corporation Reform Act would enhance S corporations' access to capital, would help preserve family-owned businesses, would remove many of the technical traps that are imposed by the current S corporation rules, and would simplify many of the cumbersome and complex rules that currently apply to S corporations.

### THE NEED FOR REFORM

The 1958 enactment of the S corporation rules provided major tax reform for small businesses. It allowed these businesses to obtain the benefits of limited liability that are associated with corporate status without being burdened by the double tax placed on corporations and their shareholders. Thus, the S corporation rules re-

moved tax considerations from the small business owner's decision to operate in corporate or non-corporate form.

Important reforms were made to these rules in 1982. However, in the last 13 years, business needs have changed and reform is needed once again. The S Corporation Reform Act would provide this needed reform by eliminating antiquated S corporation rules that impede the growth of small businesses and that burden them with unnecessary administrative complexity. Moreover, it would expand the ability of S corporations to raise capital to finance the growth of their businesses and would provide rules that would help to preserve family-owned businesses.

Some have argued that reforming the rules of Subchapter S is not needed because of the recent growth in the limited liability company (LLC) form of business enterprise. According to these arguments, most newly-formed entities will choose to be taxed as LLCs, rather than as S corporations, rendering S corporation reform a wasted effort. These arguments, however, are over-generalizations and, as a result, do not accurately reflect taxpayer behavior. In addition, even if one were to accept the suggestion that all newly-formed entities will choose to be organized as LLCs, S corporation reform is far from a wasted effort—it is essential to provide existing businesses operating as S corporations tax treatment that is close to that of LLCs.

Importantly, there currently are over 1.9 million S corporations. These corporations cannot change to LLC status without incurring significant costs. For these corporations, reforming the current rules is greatly needed—it would help them to attract capital, to keep businesses in their families, to reduce their compliance burdens and to avoid technical traps contained in the current rules. Furthermore, even disregarding the large number of existing businesses that would be assisted by reforming the rules of Subchapter S, there still are and will be situations in which newly-formed enterprises will elect to be taxed as S corporations. For example, a corporation doing business in more than one state may have concerns (e.g., liability and state tax concerns) about choosing to be taxed as an LLC. In addition, an enterprise with a single owner may not obtain tax classification as a partnership for an LLC. As a result, the S corporation form of doing business will often be chosen in this situation. Thus, reforming the S corporation rules is a necessary step and should be viewed as a complement to the growth in popularity of LLCs. America's small businesses are looking forward to this necessary reform and welcome the Subcommittee's interest in this critically-important issue.

## REFORM PROVIDED BY THE BILL

### *EXPANDING ACCESS TO CAPITAL*

The S Corporation Reform Act contains several provisions that would expand S corporations' access to capital and would allow S corporations to structure their activities more simply and efficiently. These provisions are essential to the continued growth of our Nation's small businesses.

#### *1. Permit S Corporations to Issue Preferred Stock*

Under current law, S corporations may not issue more than one class of stock. By permitting S corporations to issue preferred stock, the S Corporation Reform Act would increase access to capital from investors who insist on having a preferential return, such as venture capitalists. The bill also would facilitate family succession by permitting an older generation of shareholders to relinquish control of the corporation while still maintaining an equity interest.

#### *2. Expand Safe Harbor Debt to Permit Convertible Debt*

The S Corporation Reform Act also would permit an S corporation to issue debt that may be converted into stock of the corporation without concern that the debt will terminate the S election, provided that the terms of the debt are substantially the same as the terms that could have been obtained from an unrelated party. The provision also would permit the debt to be held, not only by a qualified shareholder, but also by a person who is actively and regularly engaged in the business of lending money. The current law provision, which does not provide a safe harbor for debt that can be converted into stock, unnecessarily impairs the ability of an S corporation to raise investment capital.

#### *3. Increase the Number of Permitted Shareholders from 35 to 50*

Currently, a corporation is not eligible to be an S corporation if it has more than 35 shareholders. The S Corporation Reform Act would increase the number of permitted shareholders to 50. This would remove one barrier to the expansion of existing S corporations and would make S corporation status available to more closely-held businesses, allowing them the benefits of limited liability. In addition, increas-

ing the number of permitted shareholders would enable S corporations to raise more capital through shareholder contributions.

*4. Permit Tax-Exempt Organizations to be Shareholders*

The S Corporation Reform Act also would increase S corporations' access to certain capital markets by permitting charities and pension plans to be eligible shareholders of S corporations. Under the bill, an S corporation would be able to establish an employee stock ownership plan and would have access to additional capital from charitable organizations and pension funds. To prevent abuse, the bill would provide that the flow-through income of an S corporation would be treated as unrelated business taxable income to a tax-exempt shareholder to the extent that the income would have been so treated if the S corporation's activities were conducted directly by the tax-exempt shareholder.

*5. Allow Nonresident Alien Shareholders to Own S Corporation Stock*

Under current law, S corporations may not have nonresident alien shareholders. The bill would enhance an S corporation's ability to expand into international markets by providing it with the ability to offer an equity interest to an individual it is trying to recruit to grow its business overseas. In addition, the bill would expand and simplify S corporations' access to foreign capital markets. This bill also would obviate the need to raise such capital through a partnership in which the S corporation is a partner. The bill would subject nonresident alien shareholders to U.S. withholding tax on S corporation income.

*6. Permit an S Corporation to Have Wholly-Owned S Corporation Subsidiaries*

The bill also would permit S corporations to have wholly-owned S corporation subsidiaries. Currently, many S corporations that conduct two or more separate businesses choose to do so by establishing separate S corporations for each business so that they can protect against risks of the other businesses. The legislation would permit an S corporation to serve as a holding company for the various operating entities which would simplify the management of the group. For example, the holding company could enter into contracts on behalf of the group, serve as common paymaster, and perform other centralized management services. One of the most important business reasons for permitting a combined group of S corporations is that it would facilitate obtaining financing for the group by providing management with the ability to present a single well-diversified enterprise to creditors.

*7. Permit an S Corporation to Hold Subsidiaries*

The S Corporation Reform Act also would allow an S corporation to own more than 80 percent of a C corporation's stock. This provision would enhance an S corporation's ability to achieve significant non-tax objectives in structuring its operations, such as limiting its liability and eliminating complications in dealing with banks, insurance companies, and other financial institutions. For example, it would allow an S corporation to isolate one or more of its businesses in subsidiaries and thereby not subject one business to the risks of another. Currently, S corporations engage in much more complicated structuring to achieve the same result.

PRESERVING FAMILY-OWNED BUSINESSES

The S Corporation Reform Act also contains a number of provisions that would make it easier for families to retain ownership of S corporations and that would advance the goal of preserving our Nation's family-owned businesses.

*1. Expand the Types of Trusts that Can Own S Corporation Stock to Include Certain Complex Trusts that Qualify as "Electing Small Business Trusts"*

The S Corporation Reform Act would enable S corporation shareholders to accomplish many estate planning goals not currently available because of current-law limitations on the types of trusts that can be S corporation shareholders. Specifically, the bill would enable S corporation shareholders to establish complex trusts with multiple beneficiaries and would permit the trustee to have discretion as to which beneficiary to make distributions. This flexibility is needed for a variety of legal reasons in situations in which there is more than one trust beneficiary—for example, in situations in which a beneficiary is a minor who cannot manage the assets. Providing this type of flexibility is consistent with a major underlying purpose of the S corporation—to provide a vehicle for family-owned corporations.

*2. Count all Members of a Single Family That Own an S Corporation's Stock as a Single Shareholder*

The S Corporation Reform Act would allow an election to be made, with the consent of all shareholders, to count family members as one shareholder for purposes

of the S corporation limitation on the number of shareholders. This election would be available to only one family in any corporation. The effect of this provision would be to permit businesses owned by large families to be S corporations, while still enabling employees or others to own an equity interest in the business. This provision would be particularly helpful to a business owned in large part by a multi-generational family that currently may face the loss of its S status if it allows additional family members a stake in the business.

REMOVAL OF TECHNICAL TRAPS FOR THE UNWARY

As explained below, the S Corporation Reform Act would eliminate many of the antiquated Subchapter S rules that add significant complexity to the compliance burdens of small businesses and that have proven to be technical traps for unwary taxpayers acting in good faith. By eliminating these rules, the S Corporation Reform Act would provide much-needed simplification of the Tax Code for America's small businesses. (Indeed, some of the provisions in the S Corporation Reform Act have been included in simplification bills addressed by previous Congresses.)

*1. Permit the Secretary of Treasury to Treat Invalid Elections as Effective and Permit Late Elections*

Because of the complexity of the S corporation rules and the need for sophisticated tax advice, taxpayers seeking to elect S corporation status are not always successful in making valid S elections. Even worse, certain taxpayers may not be aware that they did not make valid S elections, notwithstanding their good faith efforts to comply with the many complex rules of Subchapter S. Although current law permits the Internal Revenue Service (IRS) to grant relief to an S corporation that inadvertently terminates its S election, it does not permit the IRS to validate invalid elections or to extend the period of time for making S elections. Further, taxpayers seeking inadvertent termination rulings typically incur significant professional fees and filing fees.

The S Corporation Reform Act would remedy these situations by extending and modifying the authority of the IRS to grant relief. First, the bill would allow a corporation that made an invalid S election to request the IRS to validate its S election retroactively. The bill sets out criteria for the IRS to use in determining whether it should validate such elections; these criteria are the same as the current law criteria relating to inadvertent terminations of S elections.

Second, the bill would instruct the Treasury to provide for an automatic waiver procedure in inadvertent termination cases in which the Secretary deems appropriate. This automatic procedure would obviate the need for a ruling from the IRS, which, in turn, would reduce the time and money currently spent on the ruling process.

Third, the bill would provide that, if a corporation fails to make a timely S election (i.e., by the 15th day of the third month of the first S corporation year) and the Secretary determines that there was reasonable cause for such, the Secretary may treat the election as timely made. The standards currently applicable to requests for extension of time to make certain elections should apply in determining whether to grant relief to late S elections.[1]

*2. Require Only Consent of Affected Shareholders to Interim Closing of the Books on Termination of Shareholder Interest*

Current law requires that, if a shareholder terminates an interest in an S corporation during the taxable year, the corporation and all persons who are shareholders during the taxable year must agree to close the books on the date of termination. Thus, shareholders must consent even if they are unaffected by the election.

The bill would eliminate the requirement that all shareholders consent to the closing of the books and instead would require only that the "affected shareholders" (i.e., the shareholder whose interest is terminated and all shareholders to whom such shareholder transferred shares during the year) consent to the closing. This change would provide simplification and would ease procedural problems in preparing and filing timely corporate tax returns.

*3. Repeal Excessive Passive Income as a Termination Event*

Under current law, if more than 25 percent of the gross receipts of an S corporation are passive investment income, a corporate level tax will be imposed on the "excess" passive income of the corporation. In addition, the S election of the corporation will be terminated if, at the close of three consecutive years, the corporation has

[1] See Treas. Reg. §301.9100.

subchapter C earnings and profits and more than 25 percent of its gross receipts are from passive investment income.

Although the automatic termination of S status if a corporation has excess passive investment income can be avoided through careful planning, it provides a trap for some corporations—particularly for those that do not have the benefit of sophisticated counsel. Moreover, the price for falling into this trap is exceptionally high—losing S status entirely. The bill would remove this trap, while retaining sufficient disincentives to excessive passive investment income. Specifically, the bill would provide that a corporation would not lose its S corporation status if it has excess passive income for three consecutive years. Further, the bill would increase the threshold for taxing excess passive income from 25 percent to 50 percent of gross receipts. It also would clarify that items of income that are connected with an S corporation's trade or business would not be considered passive income. However, the bill also would provide that the corporate level tax rate applied to any excess passive income would increase by 10 percentage points for each successive year (up to a specified maximum increase).

*4. Permit Deemed Dividend to Avoid Passive Investment Income Tax*

Under current law, the passive investment income tax only applies if an S corporation has both passive investment income and accumulated earnings from years in which it was a regular C corporation. Therefore, a corporation currently can avoid having to pay the passive investment income tax by distributing its accumulated C corporation earnings; this distribution may be in the form of cash or property and must be made within the taxable year.

The S Corporation Reform Act would allow an S corporation to elect to be treated as if it had made a dividend distribution without actually distributing cash or property. This provision would permit an S corporation without adequate cash flow to make a distribution of its C corporation earnings and to be absolved from the passive investment income tax. This provision also would provide relief in situations in which a loan agreement prohibits an S corporation from making actual distributions. Moreover, this "consent dividend" would be a more expedient method of distributing C corporation earnings for those corporations that simply do not wish to make actual distributions.

*5. Expand to Two Years the Period of Post-Death S Qualification for Certain Trusts*

The tax law generally provides that certain trusts may not own the stock of an S corporation for more than 60 days following the grantor's death. In many circumstances, the 60-day period is insufficient to permit an executor or administrator to discover the need to transfer the shares of stock and to take the legal actions necessary to transfer the shares. As a result, the current rule has resulted in the inadvertent termination of the S election of many corporations. The bill would extend the current 60-day period to two years and, therefore, should reduce the number of such inadvertent terminations.

*6. Expand the "Post-termination Transition Period" To Cover Determinations Made on Audit*

Under current law, a corporation that terminates its S election is generally permitted to make a tax-free distribution of its earnings from its S corporation years during its "post-termination transition period." In addition, a shareholder is entitled to take losses that carry over from a corporation's S years if the shareholder obtains additional basis in his/her stock during the post-termination transition period.

Under current law, the definition of post-termination transition period does not include situations in which a corporation terminates its S status and, some time after the end of such period, adjustments are made by the IRS on audit to its S years. For example, a shareholder with suspended losses would not be able to use those losses even though audit adjustments by the IRS result in additional stock basis. The bill would rectify this technical problem by expanding the definition of post-termination transition period generally to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer, if the determination (1) follows the termination of the corporation's election, and (2) adjusts an item of income, loss, or deduction arising during its S years.

*7. Permit Tax-Free Distributions in Loss Years*

In general, a shareholder in an S corporation must reduce his/her stock basis for losses in the current year before reducing such basis for current-year distributions. In addition, a distribution in excess of a shareholder's stock basis is taxable to the shareholder. Therefore, if a shareholder receives distributions during the year, distributions may become taxable if losses during the year eliminate the shareholder's stock basis.

Because the shareholders of an S corporation may not know whether the corporation will have a loss in the current year, which could potentially deplete a shareholder's basis, there is always the possibility that a current distribution will be made taxable because of operating losses during the year. The bill remedies this situation by providing that basis first would be decreased by distributions and then by losses. The effect of this change would be to effectively delay losses (and attendant basis reduction) until after distributions are taken into account. This change would eliminate the uncertainty as to taxability of distributions and would parallel the treatment of distributions by partnerships.

*8. Preservation of One Level of Tax on Liquidation of S Corporations*

When an S corporation is liquidated, the corporation recognizes income as if it had sold all of its assets at their fair market value. The gain recognized by the corporation is taxed to the shareholders and increases their basis in stock. In addition, the Tax Code provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as received in full payment for his/her stock. These rules may effectively result in double taxation of an S corporation because any ordinary income realized at the corporate level on the distribution of its assets may not be offset by the capital loss that is recognized at the shareholder level on the liquidating distribution.

For example, assume that an individual purchases all of the stock of an S corporation for $50,000. The corporation's basis in its only asset, its inventory, is $20,000. If the individual causes the S corporation to distribute its assets in liquidation to its shareholder, the corporation is deemed to have sold its assets for their fair market value of $50,000. As a result, the shareholder is taxable on $30,000 in ordinary income, which raises his/her stock basis to $80,000. The corporation then distributes the $50,000 in assets to its shareholder in complete liquidation, generating a capital loss of $30,000. Only $3,000 of the capital loss may be offset against the $30,000 of ordinary income recognized by the shareholder. The shareholder may use the remaining capital loss in future years, but only to the extent of capital gains. Thus, the shareholder is effectively taxed twice on the lion's share of the income realized on the corporation's sale of assets. This double taxation is contrary to the single-tax regime of Subchapter S.

The bill would eliminate this potential trap (and the perverse result of double taxation) by providing that the portion of any loss recognized by a shareholder on amounts received in complete liquidation of an S corporation will be treated as an ordinary loss to the extent the shareholder's stock basis has been increased for ordinary income of the S corporation attributable to the liquidation.

CONCLUSION

S. 758 provides much needed S corporation reform. The legislation not only eliminates technical traps for S corporations created by current law, but also promotes simplification of the tax laws, enhances an S corporation's ability to access capital, and recognizes the importance of family-owned businesses.

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## STATEMENT OF THE S CORPORATION REFORM PROJECT

(SUBMITTED BY ROBERT A. BLAIR)

Mr. Chairman and Members of the Subcommittee, thank you for bringing the critical issue of capital access for entrepreneurs to this national forum, where it is my hope that real legislative answers can be found for very real problems affecting productivity and growth.

My name is Robert Blair, and I am the founder and chairman of a coalition called the S Corporation Reform Project, or "S-CORP." We are the only organization devoted exclusively to representing S corporations' federal policy concerns. S-CORP was formed in 1993, with several dozen S corporations seeking to improve the policy environment governing their business operations. Nearly two years later, through our members, affiliates and trade association affiliations, we speak on behalf of more than 40,000 S corporations nationwide.

TOPIC I: WHO ARE AMERICA'S S CORPORATIONS?

The latest Treasury Department statistics available indicate that there are between 1.6 and 1.9 million S corporations in America today. These businesses are not concentrated in any geographic region, nor are they aggregated in a particular industry. Rather, they are evenly spread across the industrial base, with about a third operating in the service sector, a third in the retail trade and financial sectors, and

a third in manufacturing, mining, agriculture and other traditionally "heavier" industries.

S corporations account for 40 percent of all U.S. corporate taxpayers, and about 11 percent of the entire corporate tax base. From these statistics, we know that S corporations are an integral part of the U.S. economy, and that they tend to be most prevalent among small- and medium-sized businesses.

The most common feature among S corporations is that they are the structure of choice for the American entrepreneur. This is so because, as an entity whose profits and losses accrue directly to its shareholders, the S corporation structure makes sense for businesses which are closely held companies, owned and operated by the same individual or group of individuals. Not surprisingly, S corporations are commonplace among family businesses. I might add that, as a logical structure for closely held start-up companies, S corporations are also quite common among the many minority and women-owned businesses that are, fortunately, becoming more prevalent on the national economic landscape.

TOPIC II: CURRENT POLICIES HINDER GROWTH

The capital concerns of S corporations are unique due to the requirements of the provisions in the Internal Revenue Code under which they were established. S corporations are hybrids: They have the pass-through taxation feature of partnerships, with limited liability features of standard, or so-called "C corporations." S corporations' operating and financial structures are also distinct. Before I discuss the particular concerns of S corporations, though, let me say that I do not believe Congress intended to set productivity traps for S corporations when it created the rules for these businesses in the late 1950's.

In fact, I would argue that, in the nearly four decades that have passed since the S corporation provisions of the Internal Revenue Code were enacted, Congressional efforts to promote entrepreneurship have been highly successful. To the contrary, by creating this special corporate structure, Congress encouraged literally millions of Americans to form new businesses.

Unfortunately, many of the rules governing S corporations are simply no longer appropriate. The S corporations that were established a generation or two ago have matured. Their operations are more complex, as are their operating needs. As a result of the growth of those businesses and the significant changes that have occurred in the business world over the past 40 years, many of the S corporations rules implemented in the 1950s to encourage entrepreneurship now restrict this business growth instead.

I do not believe that Congress sought to hinder or impede the growth of S corporations in subsequent years, when S corporation rules were updated. Instead, many of the current burdens on S corporations are the by-products of other legislative efforts. A glaring example of this was the 1993 increase in top personal tax rates, which rose from 31 percent to 39.6 percent. Since S corporation shareholders pay corporate taxes at rates which apply to individuals, the rate increase exacerbated disproportionately the tax burden borne by S corporations.

Although my task today is not specifically to argue for rate relief, I nevertheless believe that it is important to point out that S corporations have suffered a far higher increase in their tax burden than any other type of corporate entity, since the top corporate rate jumped only one percentage point and the personal rate—which is applied to S corporations—rose by almost nine times that amount. More troubling is that the increase in rates paid by S corporations made no distinction between the earnings distributed to shareholders and the funds which were reinvested in the businesses for upkeep and growth. As a direct result, S corporation shareholders pay higher taxes on their own take-home earnings and on their pro rata share of corporate reinvestment.

The unintended result of this tax policy is easily illustrated. Let us assume that an S corporation owner's "share" of her company's earnings is $250,000. Of that amount, she takes home $125,000 in wages and distributions, and invests the remaining $125,000 to purchase a new machine and hire new workers. According to current law, the owner must pay taxes on the full $250,000 as if it were income. Thus, at the end of the year, that shareholder will pay federal income taxes at an *astonishing rate of 64 percent of her actual take-home pay.* More importantly, she will pay the same tax bill as another business owner who took home $250,000 in salary and distributions and reinvested nothing.

It should not be surprising, therefore, that many S corporations are now scaling back investment in their operations. This trend is nothing short of alarming, given the importance of S corporations to the broader domestic economy and their longstanding role as job-creators and engines of U.S. economic growth.

The lesson to be learned from this, I believe, is that any broad-based economic policy that will somehow affect S corporations must take these companies and their unique corporate structure into consideration. A blind eye to the needs of S corporations is something akin to building a national highway system whose entry ramps are too narrow to accommodate 40 percent of the cars getting on. Access to opportunity is critical.

TOPIC III: RESTRICTED CAPITAL ACCESS

When burdens like this are placed on the limited capital of S corporations, it is important that alternative and accessible forms of capital be available to these companies. If capital is not easily accessible, the hypothetical access ramp is narrowed even further.

Unfortunately for S corporations, there are many other restrictions on their capital access which hinder their ability to grow. The Subcommittee will hear from business owners today who can attest to the implications of capital restrictions on their companies. Let me then explain some of the general restrictions on S corporations which directly hinder their competitiveness.

*Debt and Equity Restrictions.* First, S corporations are permitted to have only a single class of shareholders. They are not permitted to have two-tiered equity structures, or to issue debt that is convertible to equity. Because of these limitations, S corporations are unable to access capital from the many types of investors and lenders who typically prefer to be sheltered from the direct risk associated with holding common stock. They also cannot obtain equity capital without giving up to the new investors some control over the business, since all S corporation shares must take the form of a voting interest in the company.

*Limits on Shareholder Number and Type.* Current law also limits an S corporation to 35 shareholders, and further prohibits many types of shareholders—including most trusts and all tax-exempt entities—from owning S corporation stock. In addition to simply eliminating potential, additional capital sources, there are two important effects of these limits. First, family businesses which are run by either more than one family or by several generations of a single family will easily hit the shareholder limit; it is simply a matter of time. As a result, participation will have to be denied to important family members—either senior members who know the business best, or junior members who hold the most promise for the business' future.

Second, shareholder restrictions prevent S corporations from creating employee stock ownership programs, or "ESOPs." ESOPs are important sources of capital for many companies, and they are equally important sources of long-term security for many workers. Moreover, permitting employees to participate in the success of their company is arguably the best way to motivate that company's workforce.

*Limits on Corporate Control and Ownership.* S corporations are further restricted by prohibitions on their ownership of subsidiary companies. This means that S corporations cannot expand their operations through various forms of vertical integration, which may be critical to their ability to compete in a given industry. Moreover, by prohibiting S corporations from having wholly owned subsidiaries, current law also disqualifies these companies from growing through many standard types of acquisitions. This not only hurts S corporations, it also limits the pool of potential buyers of many ailing and financially troubled American businesses, which unfortunately remain in considerable supply.

These are but a few of the most onerous capital restrictions currently imposed on S corporations. Other capital restrictions exist in the form of excessive and unnecessary administrative burdens on tax planning, statutory burdens on estate planning, and the proliferation of unnecessary and obsolete tax traps which serve only to "catch" the unwary small business tax planner. Separately and together, these prohibitions restrict the growth of the sizable American S corporation community.

TOPIC IV: THE VALUE OF S CORPORATION REFORM

The good news is that legislation has been put forward in both Chambers to address many of the hurdles these companies now face. While few panaceas exist, S. 758, or the "S Corporation Reform Act of 1995," would alleviate a great number of the restrictions which plague S corporations and limit their capital access. The S Corporation Reform Project strongly supports this measure, and extends its appreciation to both Chairman Hatch and Senator David Pryor of Arkansas for their effort and insight in putting forward this far-reaching legislation.

The Hatch-Pryor bill would grant S corporations access to important types of capital which are presently unavailable. New classes of debt and equity could be issued, and the limits on the number and type of permissible shareholders would be expanded. Companies would be able to create ESOPs, and would be able to grow

through acquisitions as well as start-up efforts. Efforts to pass family businesses from one generation to the next would be enhanced through improvements to estate planning and the reclassification of all family members as a single shareholder of the company. The bill would also simplify S corporation taxes by eliminating many of the obsolete tax traps which frequently "catch" unwary S corporation tax planners, often resulting in the loss of S corporation elections.

This legislation makes good business sense for S corporations, their employees, and the economy at large. It represents an opportunity for Congress to take a proactive approach to solving real business problems.

Not only am I encouraged by what S. 758 can accomplish, I am also encouraged by the wide acceptance this legislation has gained since its very recent introduction in Congress. In only three weeks since the bill's introduction, 25 Senators have cosponsored this measure, including seven Members of the Finance Committee. Already, strong bipartisan interest has surfaced in the House, and we expect that a companion bill will soon be introduced there with equal enthusiasm. I cannot, in fact, recall the last time there was such strong, early and bipartisan support for an economic policy measure in Congress.

In addition to the S Corporation Reform Project, 24 other associations are working actively to help secure passage of this legislation this year. I believe that the proposed S Corporation Reform Act of 1995 is so widely embraced because it is a measure which represents fairness and real simplification. It encourages American entrepreneurship and growth. It recognizes the economic value that S corporations have long created. And it represents opportunity on a massive scale for a true cross-section of the U.S. industrial base and the American populace.

I applaud the Chairman for his considerable work on this measure, and for calling this hearing today to move this legislation forward in a timely fashion. I hope that others on this Subcommittee, the full Committee and the full Senate will follow Senator Hatch's and Senator Pryor's important and admirable leadership, and move to make positive S corporation reform a reality in 1995. Thank you.

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## STATEMENT OF U.S. CHAMBER OF COMMERCE

(SUBMITTED BY WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL AND DIRECTOR OF TAX POLICY)

The U.S. Chamber of Commerce appreciates this opportunity to express its support for the S Corporation Reform Act of 1995 (S. 758). The Chamber is the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad.

### BACKGROUND

Over 1.9 million small business corporations in this country have elected to be treated as S corporations for federal income tax purposes. Unfortunately, Subchapter S of the Internal Revenue Code has not kept pace with the realities of the modern business world. Its rules are outdated, restrictive, overly complex and burdensome, the result of which hinders the ability of small businesses to attract capital and grow to their full potential.

Subchapter S has undergone many changes since its inception in 1958. Various legislation altering this part of the tax code was enacted in 1982, 1984 and 1986. Even though its rules have become increasingly complex and cumbersome, S corporations continue to grow in popularity. The percentage of corporations electing S corporation status has more than doubled from 24.1 percent in 1986 to 48.4 percent in 1993. Of these corporations, approximately one-half have only one shareholder and just over that amount have no more than $100,000 in assets.

S corporations have the dual advantages of being treated like partnerships for federal income tax purposes and providing the corporate feature of limited liability protection to its shareholders. S corporation shareholders, therefore, are subject to federal income tax on their share of corporate earnings only once (at the individual level), while being limited in liability to their amounts at-risk. In addition, most states recognize S corporations for income tax purposes.

However, S corporations, by virtue of the restrictive rules and regulations which they are governed under, also suffer significant economic and procedural disadvantages. Obtaining outside capital, Preserving family-owned businesses, and adhering to the maze of tax laws can be extremely difficult, even unobtainable, for many existing S corporations. C corporations that would otherwise elect S corporation status

are dissuaded from doing so because of the growth-hindering and arcane rules currently in effect.

The rising popularity of limited liability companies (LLCs) across the country does not provide relief to many existing S corporations. In addition to being very costly for many S corporations to convert to LLCs, the LLC is not necessarily the best type of entity for all small businesses.

Substantial reform is needed so S corporations can better compete in today's increasingly sophisticated and global economy. The U.S. Chamber believes S. 758 addresses and remedies the multitude of problems that have plagued Subchapter S of the Internal Revenue Code since its inception.

MAJOR PROVISIONS OF S. 758

The S Corporation Reform Act of 1995 would update many of the current rules and assist in the growth of small businesses by expanding capital formation techniques, preserving family-owned businesses, removing undesirable tax traps, reforming the tax treatment of fringe benefits and providing for various technical proposals.

S. 758 contains several provisions that would provide S corporations additional access to capital and allow for greater flexibility. These provisions would:

*Increase the 35 shareholder limitation to 50.* Increasing the number of permissible shareholders from 35 to 50 would make S corporation status available to more closely-held businesses and enable them to raise more capital.

*Permit certain tax-exempt organizations to be shareholders.* Charitable organizations and qualified retirement plans, including employee stock ownership plans, would be able to own S corporation stock, thereby allowing S corporations to tap into new sources of investment capital. A tax-exempt shareholder's share of S corporation income would be treated as unrelated business taxable income.

*Permit nonresident aliens to be shareholders.* Allowing nonresident aliens to be shareholders in S corporations would enable these businesses to expand into international markets. In order to ensure the collection of taxes, these shareholders would be subject to U.S. withholding tax on their portion of S corporation income.

*Allow S corporations to issue preferred stock.* Under current law, S corporations may not issue more than one class of stock. Allowing S corporations to issue "plain vanilla" non-convertible preferred stock, in addition to common stock, would increase their ability to obtain capital from those investors who demand preferential treatment. Furthermore, family succession would be enhanced since older shareholders could relinquish control of the business while maintaining equity interests. Any dividends paid on such stock would be treated as interest for federal tax purposes.

*Expand safe-harbor debt to permit convertible debt and permit certain ineligible shareholders to hold such debt.* Currently, certain S corporation debt is treated as "debt" even though it could be treated as "equity" under traditional debt/equity rules. Expanding this rule to allow S corporations to issue debt that is convertible into stock would enable these businesses to raise more capital. This provision would also allow safe-harbored straight debt to be held by persons actively and regularly engaged in the business of lending money.

*Permit S corporations to hold greater than 80 percent of the stock of a C corporation.* By removing the prohibition that S corporations may not own 80 percent or more of a C corporation, S corporations could achieve various non-tax objectives, without having to devise expensive and complicated structural arrangements.

*Permit S corporations to own 100 percent of another S corporation.* This provision would allow an S corporation to serve as the holding company for various other operating S corporations, thereby simplifying the management, legal and capital-raising functions of the entire group.

S. 758 also contains provisions that would help preserve family-owned businesses. These provisions would:

*Count all members of a single family who own an S corporation's stock as a single shareholder.* As an S corporation's stock passes from one generation to another, the number of shareholders can increase significantly, causing the corporation to exceed the maximum number of permissible shareholders. This provision would permit the shareholders of an S corporation to elect to treat family members (that are not more than six generations removed from a common ancestor) as one shareholder for purposes of the shareholder limitation.

*Expand the types of trusts that can own S corporation stock to include certain complex trusts.* Currently, only certain narrowly defined trusts are permitted to

own S corporation stock. In order to provide for better estate planning, this provision would allow shareholders to establish complex trusts with multiple beneficiaries and allow trustees to decide which beneficiaries receive distributions.

S. 758 would also remove various tax traps which the unwary become subject to. These provisions would:

*Permit the Secretary of the Treasury to treat invalid elections as effective and provide for automatic waivers for certain inadvertent terminations.* Presently, the IRS may grant relief to corporations for certain inadvertent terminations of an S election. This bill would provide for an automatic waiver procedure for such inadvertent terminations, as well as additional authority for the IRS to validate otherwise invalid S elections.

*Repeal excessive passive investment income as an termination event and exclude trade or business income from the definition of passive investment income.* Currently, a corporation's subchapter S status is terminated if, at the close of three consecutive taxable years, the corporation has subchapter C earnings and profits and more than 25 percent of its gross receipts are deemed to be passive investment income. This provision would repeal such termination and, instead, provide that the corporate level tax rate applied to excess passive income increase by 10 percent for each successive year. In addition, all items of income connected to an S corporation's trade or business would not be considered passive income. The threshold for taxing excess passive income would also be increased from 25 to 50 percent of the gross receipts of the corporation.

*Treat losses from S corporation liquidations as ordinary losses to the extent it was created by ordinary income.* Currently, double taxation may result from the mismatch of ordinary income (flowing through to the shareholders) and capital losses (recognized at the shareholder level on liquidating distributions). While sophisticated tax-planning techniques can avoid such mismatching, this provision would eliminate this potential trap.

This legislation would also reform the treatment of various fringe benefits to S corporation shareholders. Specifically, these provisions would:

*Place S corporation shareholders in the same position as C corporation shareholders/employees with respect to fringe benefits.* Under current law, shareholders owning more than 2 percent of an S corporation are not eligible to exclude from income the value of otherwise excludable fringe benefits. This provision would treat S corporation shareholders the same as those in C corporations. The provision would not apply to health insurance premiums, but would apply to other fringe benefits, such as life insurance premiums.

*Repeal restrictions on qualified plan loans made to S corporation shareholders.* S corporation shareholders are currently subject to more restrictive limitations on borrowing funds from qualified business-sponsored retirement plans. This provision would eliminate this differential treatment and permit the C corporation rules to be applied to plans sponsored by S corporations.

S. 758 would also provide for several miscellaneous technical proposals. These provisions would:

*Ease the consent requirement for the interim closing of an S corporation's books upon the termination of a shareholder's interest.* Rather than requiring all shareholders to consent to close the books as of the date of a shareholder's termination, only "affected shareholders" would be required to consent to the closing of the books. This change would make it easier for corporations to file their income tax returns on a timely basis.

*Allow charitable contributions of certain items by S corporations to be treated the same as C corporations.* Under this provision, S corporations would be entitled to an increased charitable contribution, similar to the deduction allowed to C corporations.

## CONCLUSION

Together, these provisions would provide S corporations greater access to capital, preserve family-owned businesses, ease the current burdensome rules and place these businesses on a level playing field with domestic and foreign competitors.

We commend the Chairman and Senator Pryor for their longstanding commitment to implementing meaningful S corporation reform legislation. We would also like to thank the many senators who have joined in cosponsoring S. 758.

The U.S. Chamber is delighted to have had the opportunity to work with these legislators in bringing this important issue to the forefront and we look forward to working with you toward its passage. We believe S. 758 should be enacted as soon as possible so S corporations can better compete in today's business world.

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## STATEMENT OF UTELITE CORPORATION

(SUBMITTED BY CARSTEN MORTENSEN, PRESIDENT)

I am President of Utelite Corporation. This is my first trip to Washington, D.C. as a participant in a government process. I am a member of the S Corporation Reform Project. Thank you Senator Hatch and Senator Pryor for sponsoring the S Corporation Reform Act of 1995 of the S Corporation Reform Project.

Utelite Corporation has produced expanded shale aggregate for structural lightweight concrete for over 30 years. My father, his brothers, and partners started this business originally and it has stayed a closely held business. Our products allow buildings to be built stronger yet cost less money.

Our company is a S corporation with family members and key managers as shareholders. In the early days, S corporation status saved our company from bankruptcy.

S corporation status is important to us, yet our CPA tells us on a regular basis things we can't do. This makes it difficult for us to compete effectively.

I have reviewed this bill and it makes possible a number of things we would like to do today in our business.

A ESOP would be a great benefit to our workers and make us a stronger company. We want to have our workers share in our growth.

We would like to expand our plant and need additional capital and flexibility to obtain capital. This bill is important to us.

Thank you Senator Hatch and Senator Pryor for the opportunity to present this statement and thank you for your support of family business.