Calendar No. 1545

91st Congress, 2d Session } SENATE { Report No. 91–1535

CERTAIN PASSIVE INCOME OF SUBCHAPTERS CORPORATIONS

December 30 (legislative day, December 28), 1970.—Ordered to be printed

Mr. Long, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 19627]

The Committee on Finance, to which was referred the bill (H.R. 19627) having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

The Treasury Department has indicated that it has no objections to making the investment income limitation inapplicable to the type of situations dealt with in this bill.

II. REASONS FOR BILL

In 1958, Congress enacted the subchapter S provisions (secs. 1371–1377 of the code) in order to permit small business corporations and their shareholders to be taxed basically like partnerships and partners. Thus, corporations electing this status are not subject to tax but instead, for the most part, "pass through" to their shareholders the taxable consequences of their activities. This election was granted in order to minimize the effect of Federal income taxes on businessmen's choices of the form of organization in which they conduct their business.

When these provisions were first enacted, Congress determined to make them applicable only to operating businesses and not to businesses which received significant amounts of passive investment income, such as royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock or securities. Consequently, under the statute (sec. 1372(e) (5) of the code) a corporation is ineligible for subchapter S treatment if it derives more than 20 percent of its gross receipts from passive investment income sources.

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Probably the principal reason why this limitation on passive investment income was adopted was to reduce the incentive to incorporate one's investment activities merely to obtain tax deferral benefits accorded to pension, profit-sharing, and similar plans. However, with the imposition by the Tax Reform Act of 1969 [1] of the H.R. 10-type of limitation on pensions, etc., paid to a shareholder-employee of a subchapter S corporation, this reason for denying the subchapter S treatment for passive income has disappeared. Furthermore, elimination of the passive income limitation was included in the legislative proposals presented by the Treasury Department (both the 1968 and the 1969 recommendations) to simplify subchapter S and to deal with a series of other problems, such as the inadvertent terminations of elections.

The passive investment income limitation has presented especially difficult problems where corporations carrying on active businesses have realized capital gains which have unexpectedly disqualified them for subchapter S treatment. For example, the Tax Court not long ago held that passive investment income for purposes of subchapter S includes capital gains received by a corporation in the liquidation of another corporation. These gains are so treated even though the business operation is clearly active, as evidenced by the ownership by the corporation involved of more than 50 percent of the liquidated corporation's stock. As a result, in those cases where such a gain brings the corporation's passive investment income over the 20-percent limitation, the company becomes ineligible for subchapter S treatment—even though the company is basically an operating business—merely because of the liquidation of another active corporation in which it owned a controlling interest. This is true despite the fact that the corporation's controlling interest indicates that its interest in the liquidated corporation was active in nature and did not represent a portfolio investment.

This bill deals with the limited types of situations described above. The committee agrees with the House that because of the element of entrapment in these types of situations, it is appropriate to deal with them now rather than to await the longer period necessary for the complete examination of subchapter S.

III. GENERAL EXPLANATION

The bill provides that for purposes of applying the passive investment income test, a capital gain occurring upon the liquidation of a corporation is not to be considered as passive income for subchapter S purposes, if the corporation involved had more than a 50 percent interest of each class of the stock of the liquidated corporation. The

[1] The Tax Reform Act of 1969 (Public Law 91–172) provided limitations, similar to those contained in H.R. 10, with respect to contributions to retirement plans for individuals who are shareholder-employees of corporations that have elected to be taxed under subchapter S. Under the act, a shareholder-employee of a subchapter S corporation (i.e., an employee or officer who owns more than 5 percent of the shares of the corporation's stock) must include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his salary or $2,500, whichever is less.

bill does not, however, change the manner in which this gain is to be taken into account for other tax purposes. For example, the gain will continue to be taxable to the shareholders of the subchapter S corporation as a capital gain.

The bill applies to taxable years of subchapter S corporations ending after the date of enactment of this bill. The bill also provides that the amendment is to apply to any taxable year ending before October 7, 1970 (the date of this bill's introduction), if the making of a refund or the allowance of a credit is not barred on that date by any law or rule of law. If a corporation comes within the terms set forth above, then, for this amendment to apply, within 1 year after the date of the enactment of the bill the corporation must so elect and all persons (or their personal representatives) who were shareholders of the corporation at any time during any taxable year to which this amendment applies must consent to the election.

Although it is expected that an election will not be made under this provision as to past distributions unless a refund will be available, other changes caused by the election might result in deficiencies for some stockholders for some of the intervening years which may have been "closed." In order to avoid manipulation of open overpayment years against closed deficiency years, the bill provides that the statute of limitations for deficiencies for any years involved is not to expire for 1 year after the last date for filing an election under this provision.[2]

If the deficiency year would othewise have been closed, then the deficiency may not exceed the amount attributable to an election under this provision.

The bill provides special rules to prevent the denial of subchapter S status to a corporation in two cases. The first provides that this status is not to be denied because the application of the passive investment income limitations in the past caused a corporation to file its income tax return on a form 1120 (corporate tax return) instead of a form 1120S (subchapter S corporation tax return) for any year beginning before the date of enactment of this bill. The second rule provides that subchapter S status is not to be denied because the application of the investment income limitation in the past caused a new shareholder of the corporation not to file a timely consent to the subchapter S election (under sec. 1372(e) (1) of the code).

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

[2] A deficiency assessment is not to be barred by the statute of limitations under these circumstances even if the statute has already run by the time the election is made and even if an assessment would normally be barred on account of a court decision as to the taxpayers' income tax liability for that year or because a binding closing agreement had been entered into for that year between the taxpayer and the Internal Revenue Service.

SECTION 1372 OF THE INTERNAL REVENUE CODE OF 1954

Sec. 1372. Election by Small Business Corporation.

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(e) TERMINATION.—

(1) NEW SHAREHOLDERS.—An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—

(A) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) on the day on which the election is made, if such election is made after such first day,

becomes a shareholder in such corporation and does not consent to such election within such time as the Secretary or his delegate shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

(2) REVOCATION.—An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

(A) for the taxable year in which made, if made before the close of the first month of such taxable year,

(B) for the taxable year following the taxable year in which made, if made after the close of such first month,

and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(3) CEASES TO BE SMALL BUSINESS CORPORATION.—An election under subsection (a) made by a small business corporation shall terminate if at any time—

(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) after the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

(4) FOREIGN INCOME.—An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable

year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

(5) PASSIVE INVESTMENT INCOME.—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shal be effective for the taxable year of the corporation in which it has gross receipts of such amount and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). *Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.*

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