

106TH CONGRESS
1ST SESSION

H. R. 689

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 10, 1999

Mr. SHAW (for himself, Mr. MATSUI, Mr. CRANE, Mr. LEVIN, Mr. THOMAS, Mr. CARDIN, Mrs. JOHNSON of Connecticut, Mr. KLECZKA, Mr. HOUGHTON, Mr. LEWIS of Georgia, Mr. HERGER, Mrs. THURMAN, Mr. McCRERY, Mr. RAMSTAD, Ms. DUNN, Mr. COLLINS, Mr. PORTMAN, Mr. ENGLISH, Mr. WATKINS, Mr. WELLER, Mr. MCCOLLUM, Ms. MILLENDER-McDONALD, Mr. BEREUTER, Mr. PETERSON of Pennsylvania, Mr. LEACH, Mr. DOOLEY of California, Mr. STEARNS, Mr. MANZULLO, and Mr. HALL of Texas) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to provide for S corporation reform, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE;**

4 **TABLE OF CONTENTS.**

5 (a) SHORT TITLE.—This Act may be cited as the
6 “Subchapter S Revision Act of 1999”.

1 (b) AMENDMENT OF 1986 CODE.—Except as other-
 2 wise expressly provided, whenever in this Act an amend-
 3 ment or repeal is expressed in terms of an amendment
 4 to, or repeal of, a section or other provision, the reference
 5 shall be considered to be made to a section or other provi-
 6 sion of the Internal Revenue Code of 1986.

7 (c) TABLE OF CONTENTS.—The table of contents is
 8 as follows:

Sec. 1. Short title; amendment of 1986 code; table of contents.

TITLE I—ELIGIBLE SHAREHOLDERS OF AN S CORPORATION

Sec. 101. Members of family treated as 1 shareholder.

Sec. 102. Nonresident aliens allowed to be shareholders.

TITLE II—QUALIFICATION AND ELIGIBILITY REQUIREMENTS OF S CORPORATIONS

Sec. 201. Issuance of preferred stock permitted.

Sec. 202. Safe harbor expanded to include convertible debt.

Sec. 203. Repeal of excessive passive investment income as a termination event.

Sec. 204. Repeal passive income capital gain category.

Sec. 205. Allowance of charitable contributions of inventory and scientific prop-
erty.

Sec. 206. C corporation rules to apply for fringe benefit purposes.

TITLE III—TAXATION OF S CORPORATION SHAREHOLDERS

Sec. 301. Treatment of losses to shareholders.

TITLE IV—EFFECTIVE DATE

Sec. 401. Effective date.

1 **TITLE I—ELIGIBLE SHAREHOLD-**
 2 **ERS OF AN S CORPORATION**

3 **SEC. 101. MEMBERS OF FAMILY TREATED AS 1 SHARE-**
 4 **HOLDER.**

5 Paragraph (1) of section 1361(c) (relating to special
 6 rules for applying subsection (b)) is amended to read as
 7 follows:

8 “(1) MEMBERS OF FAMILY TREATED AS 1
 9 SHAREHOLDER.—

10 “(A) IN GENERAL.—For purpose of sub-
 11 section (b)(1)(A)—

12 “(i) except as provided in clause (ii),
 13 a husband and wife (and their estates)
 14 shall be treated as 1 shareholder, and

15 “(ii) in the case of a family with re-
 16 spect to which an election is in effect
 17 under subparagraph (E), all members of
 18 the family shall be treated as 1 share-
 19 holder.

20 “(B) MEMBERS OF THE FAMILY.—For
 21 purpose of subparagraph (A)(ii), the term
 22 ‘members of the family’ means the lineal de-
 23 scendants of the common ancestor and the
 24 spouses (or former spouses) of such lineal de-
 25 scendants or common ancestor.

1 “(C) COMMON ANCESTOR.—For purposes
 2 of this paragraph, an individual shall not be
 3 considered a common ancestor if, as of the later
 4 of the effective date of this paragraph or the
 5 time the election under section 1362(a) is
 6 made, the individual is more than 6 generations
 7 removed from the youngest generation of share-
 8 holders.

9 “(D) EFFECT OF ADOPTION, ETC.—In de-
 10 termining whether any relationship specified in
 11 subparagraph (B) or (C) exists, the rules of
 12 section 152(b)(2) shall apply.

13 “(E) ELECTION.—An election under sub-
 14 paragraph (A)(ii)—

15 “(i) must be made with the consent of
 16 all shareholders,

17 “(ii) shall remain in effect until termi-
 18 nated, and

19 “(iii) shall apply only with respect to
 20 1 family in any corporation.”.

21 **SEC. 102. NONRESIDENT ALIENS ALLOWED TO BE SHARE-**
 22 **HOLDERS.**

23 (a) NONRESIDENT ALIENS ALLOWED TO BE SHARE-
 24 HOLDERS.—

1 (1) IN GENERAL.—Paragraph (1) of section
2 1361(b) (defining small business corporation) is
3 amended—

4 (A) by adding “and” at the end of sub-
5 paragraph (B),

6 (B) by striking subparagraph (C), and

7 (C) by redesignating subparagraph (D) as
8 subparagraph (C).

9 (2) CONFORMING AMENDMENTS.—Paragraph
10 (4) and (5)(A) of section 1361(c) (relating to special
11 rules for applying subsection (b)) are each amended
12 by striking “subsection (b)(1)(D)” and inserting
13 “subsection (b)(1)(C)”.

14 (b) NONRESIDENT ALIEN SHAREHOLDER TREATED
15 AS ENGAGED IN TRADE OR BUSINESS WITHIN UNITED
16 STATES.—

17 (1) IN GENERAL.—Section 875 is amended—

18 (A) by striking “and” at the end of para-
19 graph (1),

20 (B) by striking the period at the end of
21 paragraph (2) and inserting “, and”, and

22 (C) by adding at the end the following new
23 paragraph:

24 “(3) a nonresident alien individual shall be con-
25 sidered as being engaged in a trade or business

1 within the United States if the S corporation of
2 which such individual is a shareholder is so en-
3 gaged.”

4 (2) APPLICATION OF WITHHOLDING TAX ON
5 NONRESIDENT ALIEN SHAREHOLDERS.—Section
6 1446 (relating to withholding tax on foreign part-
7 ners’ share of effectively connected income) is
8 amended by redesignating subsection (f) as sub-
9 section (g) and by inserting after subsection (e) the
10 following new subsection:

11 “(f) S CORPORATION TREATED AS PARTNERSHIP,
12 ETC.—For purposes of this section—

13 “(1) an S corporation shall be treated as a
14 partnership,

15 “(2) the shareholders of such corporation shall
16 be treated as partners of such partnership; and

17 “(3) any reference to section 704 shall be treat-
18 ed as a reference to section 1366.”

19 (3) CONFORMING AMENDMENTS.—

20 (A) The heading of section 875 is amended
21 to read as follows:

22 **“SEC. 875. PARTNERSHIPS; BENEFICIARIES OF ESTATES**
23 **AND TRUSTS; S CORPORATIONS.”**

24 (B) The heading of section 1446 is amend-
25 ed to read as follows:

1 **“SEC. 1446. WITHHOLDING TAX ON FOREIGN PARTNERS’**
 2 **AND S CORPORATION SHAREHOLDERS’**
 3 **SHARE OF EFFECTIVELY CONNECTED IN-**
 4 **COME.”**

5 (4) CLERICAL AMENDMENTS.—

6 (A) The item relating to section 875 in the
 7 table of sections for subpart A of part II of
 8 subchapter N of chapter 1 is amended to read
 9 as follows:

“Sec. 875. Partnerships; beneficiaries of estates and trusts; S corporations.”

10 (B) The item relating to section 1446 in
 11 the table of sections for subchapter A of chap-
 12 ter 3 is amended to read as follows:

“Sec. 1446 Withholding tax of foreign partners’ and S corporate shareholders’
 share of effectively connected income.”

13 (C) PERMANENT ESTABLISHMENT OF
 14 PARTNERS AND S CORPORATION SHAREHOLD-
 15 ERS. Section 894 (relating to income affected
 16 by treaty) is amended by redesignating sub-
 17 section (c) as subsection (d) and inserting the
 18 following new subsection after subsection (b):

19 “(c) PERMANENT ESTABLISHMENT OF PARTNERS
 20 AND S CORPORATION SHAREHOLDERS.—If a partnership
 21 or S corporation has a permanent establishment in the
 22 United States (within the meaning of a treaty to which
 23 the United States is a party) at any time during a taxable

1 year of such entity, a nonresident alien individual or for-
 2 eign corporation which is a partner in such partnership,
 3 or a nonresident alien individual who is a shareholder in
 4 such S corporation, shall be treated as having a permanent
 5 establishment in the United States for purposes of such
 6 treaty.”

7 **TITLE II—QUALIFICATION AND** 8 **ELIGIBILITY REQUIREMENTS** 9 **OF S CORPORATIONS**

10 **SEC. 201. ISSUANCE OF PREFERRED STOCK PERMITTED.**

11 (a) IN GENERAL.—Section 1361 is amended by add-
 12 ing at the end the following new subsection:

13 “(f) TREATMENT OF QUALIFIED PREFERRED
 14 STOCK.—

15 “(1) IN GENERAL.—For purposes of this
 16 subchapter—

17 “(A) qualified preferred stock shall not be
 18 treated as a second class of stock, and

19 “(B) no person shall be treated as a share-
 20 holder of the corporation by reason of holding
 21 qualified preferred stock.

22 “(2) QUALIFIED PREFERRED STOCK DE-
 23 FINED.—For purposes of this subsection, the term
 24 ‘qualified preferred stock’ means stock which meets
 25 the requirements of subparagraphs (A), (B), and (C)

1 of section 1504(a)(4). Stock shall not fail to be
 2 treated as qualified preferred stock merely because
 3 it is convertible into other stock.

4 “(3) DISTRIBUTIONS.—A distribution (not in
 5 part or full payment in exchange for stock) made by
 6 the corporation with respect to qualified preferred
 7 stock shall be includible as ordinary income of the
 8 holder and deductible to the corporation as an ex-
 9 pense in computing taxable income under section
 10 1363(b) in the year such distribution is received.”

11 (b) CONFORMING AMENDMENTS.—

12 (1) Paragraph (1) of section 1361(b) is amend-
 13 ed by inserting “”, except as provided in subsection
 14 (f),” before “which does not”.

15 (2) Subsection (a) of section 1366 is amended
 16 by adding at the end the following new paragraph:

17 “(3) ALLOCATION WITH RESPECT TO QUALI-
 18 FIED PREFERRED STOCK.—The holders of qualified
 19 preferred stock (as defined in section 1361(f)) shall
 20 not, with respect to such stock, be allocated any of
 21 the items described in paragraph (1).”

22 (3) So much of clause (ii) of section
 23 354(a)(2)(C) as precedes subclause (II) is amended
 24 to read as follows:

1 “(ii) RECAPITALIZATION OF FAMILY-
 2 OWNED CORPORATIONS AND S CORPORA-
 3 TIONS.—

4 “(I) IN GENERAL.—Clause (i)
 5 shall not apply in the case of a recap-
 6 italization under section 368(a)(I)(E)
 7 of a family-owned corporation or S
 8 corporation.”

9 (4) Subsection (a) of section 1373 is amended
 10 by striking “and” at the end of paragraph (1), by
 11 striking the period at the end of paragraph (2) and
 12 inserting “, and”, and by adding at the end the fol-
 13 lowing new paragraph:

14 “(3) no amount of an expense deductible under
 15 this subchapter by reason of section 1361(f)(3) shall
 16 be apportioned or allocated to such income.”

17 **SEC. 202. SAFE HARBOR EXPANDED TO INCLUDE CONVERT-**
 18 **IBLE DEBT.**

19 Subparagraph (B) of section 1361(c)(5) (defining
 20 straight debt) is amended by adding “and” at the end of
 21 clause (i) and by striking clauses (ii) and (iii) and insert-
 22 ing the following:

23 “(ii) in any cases in which the terms
 24 of such promise include a provision under
 25 which the obligation to pay may be con-

1 verted (directly or indirectly) into stock of
 2 the corporation, such terms, taken as a
 3 whole, are substantially the same as the
 4 terms which could have been obtained on
 5 the effective date of the promise from a
 6 person which is not a related person (with-
 7 in the meaning of section 465(b)(3)(C)) to
 8 the S corporation or its shareholders, and

9 “(iii) the creditor is—

10 “(I) an individual,

11 “(II) an estate,

12 “(III) a trust described in para-
 13 graph (2), or

14 “(IV) a person which is actively
 15 and regularly engaged in the business
 16 of lending money.”

17 **SEC. 203. REPEAL OF EXCESSIVE PASSIVE INVESTMENT IN-**
 18 **COME AS A TERMINATION EVENT.**

19 (a) IN GENERAL.—Section 1362(d) (relating to ter-
 20 mination) is amended by striking paragraph (3).

21 (b) CONFORMING AMENDMENTS.—

22 (1) Section 1362(f)(1) is amended by striking
 23 “or (3)”.

1 (2) Clause (i) of section 1042(c)(4)(A) is
 2 amended by striking “section 1362(d)(3)(C)” and
 3 inserting “section 1375(b)(4)”.

4 **SEC. 204. REPEAL PASSIVE INCOME CAPITAL GAIN CAT-**
 5 **EGORY.**

6 Subsection (b) of section 1375 is amended by striking
 7 paragraphs (3) and (4) and inserting the following new
 8 paragraphs:

9 “(3) SUBCHAPTER C EARNINGS AND PROF-
 10 ITS.—The term ‘subchapter C earnings and profits’
 11 means earnings and profits of any corporation for
 12 any taxable year with respect to which an election
 13 under section 1362(a) (or under section 1372 of
 14 prior law) was not in effect.

15 “(4) PASSIVE INVESTMENT INCOME DE-
 16 FINED.—

17 “(A) IN GENERAL.—Except as otherwise
 18 provided in this paragraph, the term ‘passive
 19 investment income’ means gross receipts de-
 20 rived from royalties, rents, dividends, interest,
 21 and annuities.

22 “(B) EXCEPTION FOR INTEREST ON
 23 NOTES FROM SALES OF INVENTORY.—The term
 24 ‘passive investment income’ shall not include in-
 25 terest on any obligation acquired in the ordi-

1 nary course of the corporation's trade or busi-
2 ness from its sale of property described in sec-
3 tion 1221(1).

4 “(C) TREATMENT OF CERTAIN LENDING
5 OR FINANCE COMPANIES.—If the S corporation
6 meets the requirements of section 542(c)(6) for
7 the taxable year, the term ‘passive investment
8 income’ shall not include gross receipts for the
9 taxable year which are derived directly from the
10 active and regular conduct of a lending or fi-
11 nance business (as defined in section
12 542(d)(1)).

13 “(D) TREATMENT OF CERTAIN DIVI-
14 DENDS.—If an S corporation holds stock in a
15 C corporation meeting the requirements of sec-
16 tion 1504(a)(2), the term ‘passive investment
17 income’ shall not include dividends from such C
18 corporation to the extent such dividends are at-
19 tributable to the earnings and profits of such C
20 corporations derived from the active conduct of
21 a trade or business.

22 “(E) COORDINATION WITH SECTION
23 1374.—The amount of passive investment in-
24 come shall be determined by not taking into ac-
25 count any recognized built-in gain or loss of the

1 S corporation for any taxable year in the rec-
2 ognition period. Terms used in the preceding
3 sentence shall have the same respective mean-
4 ing as when used in section 1374.”

5 **SEC. 205. ALLOWANCE OF CHARITABLE CONTRIBUTIONS**
6 **OF INVENTORY AND SCIENTIFIC PROPERTY.**

7 (a) IN GENERAL.—Section 170(e) (relating to certain
8 contributions of ordinary income and capital gain prop-
9 erty) is amended—

10 (1) by striking “(other than a corporation
11 which is an S corporation)” in paragraph (3)(A),
12 and

13 (2) by striking clause (i) of paragraph (4)(D)
14 and by redesignating clauses (ii) and (iii) of such
15 paragraph as clauses (i) and (ii), respectively.

16 (b) STOCK BASIS ADJUSTMENT.—Paragraph (1) of
17 section 1367(a) (relating to adjustments to basis of stock
18 of shareholders, etc.) is amended by striking “and” at the
19 end of subparagraph (B), by striking the period at the
20 end of subparagraphs (C) and inserting “, and”, and by
21 adding at the end the following new subparagraph:

22 “(D) the excess of the deductions for char-
23 itable contributions over the basis of the prop-
24 erty contributed.”

1 **SEC. 206. C CORPORATION RULES TO APPLY FOR FRINGE**
 2 **BENEFIT PURPOSES.**

3 (a) IN GENERAL.—Section 1372 (relating to partner-
 4 ship rules to apply for fringe benefit purposes) is repealed.

5 (b) PARTNERSHIP RULES TO APPLY FOR HEALTH
 6 INSURANCE COSTS OF CERTAIN S CORPORATION SHARE-
 7 HOLDERS.—Paragraph (5) of section 162(l) is amended
 8 to read as follows:

9 “(5) TREATMENT OF CERTAIN S CORPORATION
 10 SHAREHOLDERS.—

11 “(A) IN GENERAL.—This subsection shall
 12 apply in the case of any 2-percent shareholder
 13 of an S corporation, except that—

14 “(i) for purposes of this subsection,
 15 such shareholder’s wages (as defined in
 16 section 3121) from the S corporation shall
 17 be treated as such shareholder’s earned in-
 18 come (within the meaning of section
 19 401(c)(1)), and

20 “(ii) there shall be such adjustments
 21 in the application of this subsection as the
 22 Secretary may by regulations prescribe.

23 “(B) 2-PERCENT SHAREHOLDER DE-
 24 FINED.—For purposes of this paragraph, the
 25 term ‘2-percent shareholder’ means any person
 26 who owns (or is considered as owning within

1 the meaning of section 318) on any day during
 2 the taxable year of the S corporation more than
 3 2 percent of the outstanding stock of such cor-
 4 poration or stock possessing more than 2 per-
 5 cent of the total combined voting power of all
 6 stock of such corporation.”

7 (b) CONFORMING AMENDMENT.—The table of sec-
 8 tions for part III of subchapter S of chapter 1 is amended
 9 by striking the item relating to section 1372.

10 **TITLE III—TAXATION OF S** 11 **CORPORATION SHAREHOLDERS**

12 **SEC. 301. TREATMENT OF LOSSES TO SHAREHOLDERS.**

13 (a) LIQUIDATIONS.—Section 331 (relating to gain or
 14 loss to shareholders in corporate liquidations) is amended
 15 by redesignating subsection (c) as subsection (d) and by
 16 inserting after subsection (b) the following new subsection:

17 “(c) LOSS ON LIQUIDATIONS OF S CORPORATION.—

18 “(1) IN GENERAL.—The portion of any loss rec-
 19 ognized by a shareholder of an S corporation (as de-
 20 fined in section 1361(a)(1)) on amounts received by
 21 such shareholder in a distribution in complete liq-
 22 uidation of such S corporation which does not exceed
 23 the ordinary income basis of stock of such S cor-
 24 poration in the hands of such shareholder shall not

1 be treated as a loss from the sale or exchange of a
2 capital asset but shall be treated as an ordinary loss.

3 “(2) ORDINARY INCOME BASIS.—For purposes
4 of this subsection, the ordinary income basis of stock
5 of an S corporation in the hands of a shareholder of
6 such S corporation shall be an amount equal to the
7 portion of such shareholder’s basis in such stock
8 which is equal to the aggregate increases in such
9 basis under section 1367(a)(1) resulting from such
10 shareholder’s pro rata share of ordinary income of
11 such S corporation attributable to the complete liq-
12 uidation.”

13 (b) SUSPENDED PASSIVE ACTIVITY LOSSES.—Para-
14 graph (3) of section 1371(b) is amended to read as fol-
15 lows:

16 “(3) TREATMENT OF S YEAR AS ELAPSED
17 YEAR; PASSIVE LOSSES.—Nothing in paragraphs (1)
18 and (2) shall prevent treating a taxable year for
19 which a corporation is an S corporation as a taxable
20 year for purposes of determining the number of tax-
21 able years to which an item may be carried back or
22 carried forward nor prevent the allowance of a pas-
23 sive activity loss deduction to the extent provided by
24 section 469(g).”

1 **TITLE IV—EFFECTIVE DATE**

2 **SEC. 401. EFFECTIVE DATE.**

3 (a) IN GENERAL.—Except as otherwise provided in
4 this Act, and in section 1362(g) relating to elections after
5 termination, the amendments made by this Act shall apply
6 to taxable years beginning after December 31, 1999.

7 (b) TREATMENT OF CERTAIN ELECTIONS UNDER
8 PRIOR LAW.—For purposes of section 1362(g) of the In-
9 ternal Revenue Code of 1986 (relating to election after
10 termination), any termination or revocation under section
11 1362(d) of such Code (as in effect on the day before enact-
12 ment of this Act) shall not be taken into account.

○