S CORPORATIONS-THEIR HISTORY AND CHALLENGES

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TUESDAY, JUNE 27, 2006

HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON REGULATORY REFORM AND OVERSIGHT
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. W. Todd Akin [Chairman of the Subcommittee] presiding.

Present: Representatives Akin, Kelly, Bordallo.

Chairman AKIN. The Committee will come to order.

I'd like to open by saying good morning to everyone and welcome to the hearing entitled "S Corporations—Their History and Challenges." And, obviously, providence is smiling on those of you who could make it through the rain clouds. I think we have one out of five witnesses that can't join us today because of the weather.

This is about the history and challenges of these S Corporations, which was a bit of a new subject to me. So I think it may be of interest to others here as well.

And I want to just thank you. I know that we have some really, really competent people that are going to be testifying. I want to thank you all for coming.

We are here to take a look at this, the important business structure that has helped to foster an entrepreneurial environment since the late 1950's. Prior to the development of this corporate structure, entrepreneurs had two options in creating a business entity. They could form a partnership, which would allow for a single layer of tax on profits, but expose the entrepreneur to higher levels of risk. Or, they could form a C corporation, which would shield the entrepreneur from risk, but create a double layer of tax on profits.

Neither business structure adequately addressed the needs of entrepreneurs and so in 1958 Congress and President Eisenhower acted to create the S corporation. The S corporation allows for limited liability and a single layer of taxation for small closely held businesses. The adoption of subchapter S was a huge step forward in encouraging small and family-owned businesses in America.

Today, S corporations are the most popular corporate entity. The IRS estimates that there were 3.2 million S corporation owners in the United States in 2003, compared to approximately 2.1 million C corporations and 2.3 million LLCs and other partnerships.

But while the S corporation community has grown and matured, the rules governing S corporations have remained largely the same. The number of shareholders is still limited, an S Corporation may have only a single class of stock, and the rules will still limit who or what may own shares in an S corporation. Today we will hear testimony expounding on:

First, the history of S corporations and the role they have played in encouraging the rise of small and closely-held businesses and in the U.S. economy;

Second, the unique challenges S corporations face with the rules governing subchapter S;

Third, legislative proposals to modernize the S corporation structure; and

Lastly, the IRS National Research Program study of S corporations.

I look forward to learning more about how S corporations benefit the American entrepreneur and what more can be done to aid this important component of the U.S. economy.

I now yield to the gentlelady from Guam, Madame Bordallo and for her comments.

[Chairman Akin's opening statement may be found in the appendix.]

Ms. BORDALLO. Thank you very much, Mr. Chairman. And I join you, too, in getting to know a little bit more about the S corporations.

I would like to welcome our witnesses this morning. In spite of the bad weather you are able to get here. We appreciate that.

Small businesses drive our economy. And it is critical that our country's small businesses remain strong and vibrant. It is this Committee's responsibility to facilitate achieving that goal in any way that we can. Reviewing the benefits of and potential modifications to the S Corporation business model is important to our nation's small businesses, as many of them are indeed S corporations. Legal and regulatory structures must reflect the pressures of the modern business. And they must be written in a way that does not put small business at a disadvantage. Our country's small businesses must be allowed to remain competitive in today's fast-paced marketplace.

The number of small businesses that have been organized as S corporations has tripled from around 1 million to 3.25 million over the last 20 years.

Among other things, the S corporation offers a number of appealing tax benefits and protections against personal liability. And I am sure we are going to learn a great deal more about that today.

For instance, the S corporation classification allows entrepreneurs to avoid a "double tax" on their corporate and shareholder dividend earnings.

The S corporation also provides a form of insulation for small businesses to be more confident in moving forward with their innovative ideas and their ventures.

S corporation classification is a proven way for small businesses to achieve the benefits of corporate ownership. But there are still a number of barriers preventing S corporations from reaching their

full potential for growth. And I look forward to hearing today's discussion on how we can work to ensure that the S corporations remain a strong and viable option and to learn about some of their concerns. I thank you very, Mr. Chairman.

[Ranking Member Bordallo's opening statement may be found in the appendix.]

Chairman AKIN. Thank you.

And I know that a few of you here, at least, Tom, you know the rules and what we try to do. I think this makes it easiest for our hearing to proceed in an orderly fashion if we take a statement from each of you. If you would like to submit a written testimony, that would be fine as well.

And what we would like to do is to hold you to five minutes each. We will go straight across. And then that will allow us to get to asking some questions.

I think we can wrap things up usually in close to an hour or so. So that would be a reasonable thing in terms of time expectations.

So our first witness is no stranger, the Honorable Tom Sullivan, Chief Counsel for Advocacy United States Small Business Administration, Washington, D.C. And a friend of the Committee and a friend of small business.

Tom, please lead off

STATEMENT OF THE HONORABLE THOMAS M. SULLIVAN, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SULLIVAN. Thank you, Mr. Chairman, Congresswoman Bordello.

It is truly an honor to appear, not only before this Committee, but also as part of this distinguished panel.

My name is Tom Sullivan, and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration.

I would like to submit my complete written statement. And as the Chair referenced, just briefly summarize in five minutes.

Chairman AKIN. Without objection.

Mr. SULLIVAN. The Office of Advocacy, is an independent office with the Small Business Administration. Therefore, the comments expressed here don't necessarily reflect the position of the Administration or the SBA.

Small businesses are a driving force in the United States economy. They compromise 99.7 percent of all employer firms, employ half of all the private sector workers and have generated 60 to 80 percent of the net new jobs annually over the last decade.

Small firms pay 45 percent of the total U.S. private payroll, and create about half of the non-farm private gross domestic product.

Small businesses also tend to innovate at a higher rate than medium or large businesses, producing up to 14 times the patents per employee than their larger business counterparts.

And finally, during economic downturns small businesses fair better than their larger counterparts. Increases in small business employment and self-employment often help steer the economy out of recessions.

Just as small businesses are the cornerstone of the U.S. economy, S-corporations are the cornerstone of the small business economy. According to IRS Statistics of Income for tax year 2002 there

were approximately 3.1 million S-corporation returns filed, making up 59.6 percent of all corporate returns. Those same S-corporations generated $3.9 trillion in annual revenue.

The written testimony discusses the history of S-corps, the complexity by which S corps can be started and operate and the need to update laws for S corps to continue to grow as a viable business structure.

My office is supportive of legislative efforts that will enhance the growth of S corps. We are concerned, however, as the small business community is concerned, with what some view as unfair scrutiny of S corps by the IRS.

The National Research Program has been described by IRS as a program that will fill data gaps needed to ensure efficient tax enforcement and prioritization. That is far different from what small businesses say is an audit initiative focused on S corps. I'm all for IRS proceeding with better information, but I share the concerns of small businesses with how IRS appears to be focusing its in depth, and I might add painful, audits on S corps.

Research sponsored by my office continues to show that the cost of tax compliance costs $1304 per employee per year for firms with under 20 employees. That's 67 percent higher than large firms.

Facing an audit, obviously, increases the costs of tax compliance by requiring business owners to incur the expense of representation and it takes time away from their business to answer IRS inquiries.

Small businesses take their responsibility to pay their fair share of taxes seriously. No one wants to defend those that deliberately cheat the system. However, IRS's approach may punish those that voluntarily comply with the law based on the failures of those who do not.

In summary, small businesses have a long history of contributing greatly to the American economy. S-corporations play a critical role in keeping the economy strong. To ensure their continued success, government has to be wary of taking steps that may stifle the entrepreneurial growth of S-corporations. Legislation introduced to reform S-corporation provisions should be based on tax policy that enhances entrepreneurial competitiveness H.R. 4421 accomplishes this. As the IRS strengthens tax compliance efforts, attention should be given to why taxpayers become noncompliant so that recommendations are tailored to meet those challenges.

Thank you for allowing me to present these views. And I am happy to answer questions.

[The Honorable Thomas Sullivan's testimony may be found in the appendix.]

Chairman AKIN. Tom, you are starting off pretty well. You redeemed 30 seconds there. Good job, and what you said raises a lot of interesting questions. I appreciate your coming out and chatting with us on the subject.

Our next witness is the Honorable Don Alexander. And Don is a partner at Akin, Gump, Strauss, Howard & Feld and former IRS Commissioner from Washington, D.C. And as he has told me earlier this morning, he's probably forgotten a lot of what he once knew but I suspect still knows a lot more than a lot of other people.

Don, we are just delighted to have you here. Please share what your thoughts are on the subject.

STATEMENT OF THE HONORABLE DONALD C. ALEXANDER, AKIN, GUMP, STRAUSS, HOWARD & FELD

Mr. ALEXANDER. Delighted to be here.

I have a long statement to make, it's historical. And I request that it be inserted in the record. I don't intend to read any of it.

Chairman AKIN. No objection.

Mr. ALEXANDER. 1958 was the year which sub S appeared as legislation adopted by the House and Senate and signed by the President.

1958 happened to be one of my better years.

Chairman AKIN. If you could slide that mike just a little closer.

Mr. ALEXANDER. I will.

Chairman AKIN. Thank you very much.

Mr. ALEXANDER. Two mikes. Wow. Well, that takes me back to 1958. I didn't have two mikes in 1958. But we had sub S in 1958 because the Eisenhower Administration thought that there ought to be a way for small business to have a vehicle, a way of conducting their business that would give them the corporate limited liability, which you really have to have these days. Even then you had to have. And at the same time not have a double tax. Once when the vehicle itself paid a tax and then when it distributed some of its profits to its owners, and low and behind there was another tax.

Well, we still have that today. We do not have the same rates that we had then. We had a rate on individual income that went to 91 percent. Very few people paid it, willingly anyway, or unwillingly for that matter. Because IRS didn't do very much about it.

Then in the Reagan Administration we got the rate down to 70 percent, 70 percent that is on unearned income and got to 50 percent finally on earned income. We treated earned income better than unearned income then, far different than what we do today.

Anyway, sub S was enacted to try to help small businesses carry out their role as essential to the U.S economy as Mr. Sullivan as just pointed out and as you pointed out in your opening statements, in a simple form. Well, the idea was a simple structure for simple people. The problem is that Sub S through the years and in my statement I mentioned the changed that have been made, almost all of them except one in the right direction since 1958, tried to alleviate the shackles that were put on sub S corporations back in 1958, and that still exists. Shackles to try to make the corporate structure simple, but shackles which now make the corporate structure rigid and rigidity is not simplicity. They are two different things.

Originally only ten stockholders could own stock in a sub S corporation. Now, thanks to a number of remedial actions by the Congress, that ten has risen to a 100. It ought to be about 150 so that small banks which have to adopt the sub S form because they can't go into the fancy things like partnerships and LLC, can have a sufficient number of member stockholders to survive in competition with the giant banks that we have today.

Other changes should be made. You will hear more about these from the other witnesses. But in my litany of history I point out while the rules governing sub S corporations have been modified over the years and improved over the years, sub S corporations although numerous are not the vehicle of choice anymore. They're not the vehicle best suited from the tax standpoint for a small business to use. Instead, we have limited liability corporations, limited liability partnerships and we have something called check the box where you can decide whether you want to be a tax nothing or a tax something when you go into business. Whether those regulations are valid or not is another question, but they are with us and who is going to contest them.

All this has worked to the disadvantage of sub S corporations. While they are numerous, and as you pointed out they are competing with LLCs and others that don't have the strictures still limiting sub S corporation.

[The Honorable Donald Alexander's testimony may be found in the appendix.]

Chairman AKIN. Thank you very much. I appreciate your testimony. We will look forward to getting back to you with some questions.

Our next witness is James Redpath, CPA, partner, HLB Tautges Redpath, LTD., is that somewhere close?

Mr. REDPATH. Close enough, yes.

Chairman AKIN. From White Bear Lake, Minnesota. Did you fly in?

Mr. REDPATH. Last night.

Chairman AKIN. Did you? That was a treat, was it not?

Mr. REDPATH. Yes, it was.

Chairman AKIN. Yes. Well, we appreciate your braving the weather and joining us here, James.

Please proceed.

STATEMENT OF JAMES REDPATH, CPA, HLB TAUTGES REDPATH, LTD.

Mr. REDPATH. Chairman Akin, Ranking Member Bordallo, thank you for the opportunity to testify. My name is Jim Redpath. I am a certified public accountant and an officer at HLB Tautges Redpath, Ltd., a 100 person full-service accounting firm serving clients in the greater Minneapolis/St. Paul metropolitan area. Our firm, like many others, work with several hundred S corporations. I also serve as Chairman of the Advisory Board to the S Corporate Association. My goal is to provide you with a firsthand account of how the rules governing S corporations are outdated, and how those rules might be improved.

I ask that my full written testimony be placed in the record.

Chairman AKIN. Without objection.

Mr. REDPATH. Thank you.

Last year, our firm was involved in creating more than 100 business entities for clients. Of those, virtually all were LLCs and only a select few were S corporations.

When S corporations were created in 1958, their benefits were tied to the following restrictions, as earlier stated: The number of shareholders was limited; the types of shareholders were restricted,

and; only one class of stock was allowed. Failure to comply with those rules result in the loss of S corporation status and unexpected double taxation.

In contrast, the LLC was created by states beginning around 19977 and evolving through 1997. And the LLC is encumbered with none of the rules governing and limiting S corporations.

When an entrepreneur sits down in my office to discuss starting a business, these differences play a leading role in our conversation. Why would someone subject themselves to the S corp restrictions and the possibility of inadvertent double taxation? Therefore, most new businesses choose to be an LLC. But what about the existing 3 plus million S corporations? Should they convert to LLCs? Generally the answer is no. Converting from an S corporation to an LLC is a taxable event where you pay taxes on any appreciated property owned by the business. In my experience, no one is willing to go through the pain to gain LLC status. Therefore, I believe each of the S corporation rules need to be reviewed to determine their appropriateness for the 3 plus million S corporations in existence.

Another area of challenge for S corporations occurs during the transition of the business from one generation to the next. If you have a family owned business with multiple shareholders and multiple generations, the ability to issue different classes of stock really helps keep family members involved in the family business. But S corporations cannot issue preferred stock or other classes of stock. Allowing S corporations to have multiple classes of stock would dramatically improve their ability to make this transition.

Mr. Chairman, the tax code includes a number of provisions designed to ensure that businesses converting from C to S corporations do not enjoy a tax windfall when they make the conversion, mainly LIFO recapture, passive investment tax and built-in gains tax. I believe in certain circumstances these provisions go too far.

For example, S corporations For example, S corporations are subject to a corporate level tax on certain income and gains recognized within 10 years after they convert from C to S corporation. I find the built-in gains provision causes many S corporations to hold onto unproductive assets and business lines that should be sold or converted and reinvested into the business. Ten years is a long time. Reducing the build-in gains tax period from ten to seven years, modifying the passive investment income limitation and eliminating the passive investment income determination event would eliminate an unnecessary advantage to S corporations.

Mr. Chairman, raising capital is always a challenge for a closely held business, even without the additional limitation faced by S corporations. When S corporations were created, the idea was a simple corporate form for simple business. The business world has changed in the past 50 years, and the limitations imposed on those simple businesses are now restricting the ability of established S corporations to access the capital they need. Allowing S corporations to issue additional classes of stock, convertible debt and allowing non-resident aliens and IRAs as shareholders will enhance the ability of S corporations to access necessary capital.

Mr. Chairman, the S corporation is the only business structure where you can where you can inadvertently lose your entity tax status. An S corporation election is terminated whenever the S cor-

poration has excessive passive income, too many shareholders, an ineligible shareholder, or an arrangement that may be considered a second class of stock. Often, businesses are unaware that they have violated these restrictions and it is discovered too late. This rule has tangible impact on S corporations.

In the last year I was involved in three transactions where the remote possibility of the entity failing to satisfy it S corp requirements since the day of its inception stopped the transaction or resulted in major modifications to the terms. Allowing S corporations without IRS consent to rectify an ineffective election or a terminating event, increases tax status certainty to S corporations and puts them on par with all other entities.

The S corporation has proven to be a huge success, but times have changed, and the rules governing S corporations need to change as well.

Legislation like Representative Shaw's bill H.R. 4421, Representative Ramstad's bill H.R. 2239, and others would greatly improve these rules and enable S corporations to continue to compete with LLCs and other business structures on a more even footing and promote economic investment and growth for S corporations. By contrast, S corporations remain concerned about—

Chairman AKIN. James, your time is getting a little close here.

Can you summarize things here? I mean, I think you have been summarizing it, but just cap it off.

Mr. REDPATH. Yes. In summary there was a proposal relating to an increased tax on S corporations relating to payroll taxes. This for small corporations would result in a 15 percent increase in their tax. We believe the Treasury has the ability to enforce the existing rule that prohibit abuse.

Thank you for your time.

[Mr. Redpath's testimony may be found in the appendix.]

Chairman AKIN. Thank you, James.

And our next witness is Gregory Porcaro. Do you go by Greg or Gregory?

Mr. PORCARO. Greg is fine, thank you.

Chairman AKIN. Okay. And Greg is with the American Institute of Certified Public Accountants from Warwick, Rhode Island.

Mr. PORCARO. Sir.

Chairman AKIN. A pleasure to have you here this morning, Gregory.

STATEMENT OF GREGORY PORCARO, CPA, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PORCARO. Thank you. It's a pleasure to be here.

Good morning, Chairman Akin, Ranking Member Bordallo and other distinguished members of this Subcommittee, the American Institute of Certified Public Accountants appreciates this opportunity to present testimony on the place of S corporations in our society and on the need to keep them vital and competitive by continuing to modernize the laws that govern Subchapter S of the Internal Revenue Code. We request that a written copy of this testimony be included in the official record of this hearing.

Chairman AKIN. Without objection

Mr. PORCARO. Thank you.

My name is Gregory Porcaro and I am the Chair of the AICPA S Corporation Technical Resource Panel. AICPA members assist S corporations of all sizes and in all industries nationwide, and their shareholders, with choice-of-entity decisions; transactional planning, return preparation; and many other services required daily by S corporations. It is from close involvement with our clients that we have developed insight into the impact of S corps on our society and into needed changes that will enable S corps to continue to be a primary vehicle for both start-ups and existing businesses to achieve operational growth, expanded employee ownership, and simplified and practical family succession planning. Personally, I am a majority shareholder and tax principal in a small CPA firm in Rhode Island PA who serves S corporation clients ranging in size from $50,000 in revenue to $40 million in revenue. My firm annually prepares close to 600 S corporation tax returns, including our own.

S corporations are active in just about every sector of our environment and economy from professional service, construction, manufacturing, retail and wholesale establishments; the majority of corporate businesses that we deal with everyday are, in fact, S corporations. Recent numbers indicate that there are 3° S corporations that together have invested over $2.5 billion in assets, generated substantial revenue and contributions to our economy and employ millions of people. These engines of American entrepreneurship are not slowing down even with the fast growth of LLCs that still harbor certain advantages over S corporations today.

Today, in our brief testimony I will cover some of the statutory changes that we believe should be made to Subchapter S. Collectively, these changes would eliminate needless traps, inequities, and complexities, indeed, may help many corporations actually make an S election. Subchapter S can and should be modernized to expand its reach, to simplify transactions and remove unintended consequences.

Start-up business survivability is a critical concern. Census data indicates that 20 percent of start-up companies disappear after one year, and 70 percent disappear after ten. Small businesses that struggle with and file for bankruptcy over operational, financial, and tax problems may be able to prevent these problems if they have greater access to their CPAs. The AICPA, therefore, supports the Small Business Tax Flexibility Act of 2005, H.R. 4006, and its 2006 companion bill in the Senate, which would give most S corporations and partnership start-ups the flexibility to adopt a fiscal year-end from April through November. This flexibility would help spread start-up businesses' regulatory, financial, and tax burdens away from the busiest operational periods, thus increasing productivity; it will help spread regulatory, financial and tax workload of CPAs and other advisors throughout the year, thus promoting a more balanced family-work protocol for advisors;

Increase the occurrence of non-extendable financial and regulatory deadlines, such as bank loan submissions or HUD filings outside of the tax season;

Provide the same flexibility that C corporations, which are typically larger businesses, have in choosing the right fiscal year-end for the business, and;

Provide certain start-ups with increased cash flow because both real and opportunity costs will be reduced as the result of performing these tasks outside of their busy portion of their business cycle.of compliance are reduced as such work is delayed to a less productive period of the business cycle.

Another area of concern is a recent discussion to change the way S corporation shareholders pay employment taxes. The Joint Committee on Taxation has suggested that S corporation shareholders switch from the current withholding tax regime to the estimated tax payment system. Without addressing the merits and concerns of the Joint Committee at this time, we strongly suggest that if any changes are made, that they not be made to the S corporation regime, but rather that the issue should be studied carefully with extensive input from public to consider moving the partnership model closer to the S corporation model of payroll tax withholding. S corporation shareholders should not be brought into the less efficient system of self-employment and estimated tax system because the current payroll withholding system substantially decreases the likelihood that a taxpayer will underpay their tax liability as comprehension and compliance with that system is much easier and less burdensome.

Next I will mention the few suggestions that we find are of particular importance:

Removal of the tax on LIFP Recapture;

Electing Small Business Trust should be able to deduct interest on debt expense incurred when it borrows funds to purchase S corporation stock.

In conclusion, the AICPA has a number of other recommendations that we do not have time to mention today. We ask that a letter to Senators Hatch and Lincoln describing these recommendations in great detail be included in the record of this hearing.

Chairman AKIN. Without objection.

Mr. PORCARO. We are pleased to be able to present this testimony before you today and will be delighted to answer any questions.

Thank you, Mr. Chairman and Members of this Subcommittee.

[Mr. Porcaro's testimony may be found in the appendix.]

Chairman AKIN. Thank you, Gregory, for your testimony.

Maybe in asking some questions, I will start with you. Gregory, you are one of the few people that did not mention 4421. Are you familiar with that piece of legislation. I think it's Clay Shaw's bill?

Mr. PORCARO. I am, sir.

Chairman AKIN. Does that bill help or harm the S corps in your opinion?

Mr. PORCARO. We have been monitoring that bill at the AICPA since it first came about several years ago. And we believe those provisions are going to be significantly helpful in providing a lot of the flexibility that was referenced here today.

Chairman AKIN. So even though you did not specifically mention it in your testimony, you think it is going the right direction then?

Mr. PORCARO. Yes, sir.

Chairman AKIN. Okay.

And the better questions for Mr. Sullivan, do you dispute that we have a tax gap?

Mr. SULLIVAN. No, I do not dispute that, Mr. Chairman.

Chairman AKIN. So we do have a tax gap?

Mr. SULLIVAN. We do have a tax gap. I think there has to be some balance in figuring out how to try to fill to the extent practicable that tax gap. And I think from that perspective the small business community differs from IRS' approach.

Chairman AKIN. And then also, S corporations receive tax benefits for making an S election. Why should they receive more benefits?

Mr. SULLIVAN. Mr. Chairman, the answer on why there should S corp reform to make them do better really is a broad economic answer. And that is an examination of the success of S corps reveals an incredible contribution to this economy. So to say why should they get benefits, the answer is because when they benefit, the entire economy benefits.

Chairman AKIN. Let me just sort of step back for what I am hearing and see if I am picking up, more or less, what is going on. We created S corps because we needed something to help get small businesses off the ground. We just didn't have the right legal mechanism, taxing mechanism to really encourage small business. So we created this S corp back under Eisenhower in the '50s. And at the time it was good technology, but when we look at it today it just created a whole lot of red tape and hassles and a tremendous liability. It is not a liability in the sense of some lawyer is going to sue you out of your house. It is not a tax liability—well, it is sort of a tax liability, but it is rather that if you make some little nitpicking mistake, all of a sudden you can lose the whole structure that you organized under. Not only that, you have to pay an incredible amount of back taxes, which I assume might even destroy the viability, the financial viability of your company. So it has got an awful lot of gotchas in it, a lot of complexity to the point that people are not even recommending it anymore if you are starting business up.

So we have a certain number of people almost trapped in this antique system. And the question is whether we are going to get with the program and get this thing changed.

Now, first of all, am I stating the problem more or less correctly? I see nods, more or less.

Okay. Then why has it taken us so long to get the job done? Does anybody disagree with what I just said? I mean, what groups of people would disagree? IRS?

Mr. ALEXANDER. No. Mr. Chairman, I might try to answer that.

If I were still back with IRS, I would be paranoid enough to believe that—oh well.

Now, Mr. Chairman, you put your finger right on it. S corps were supposed to be simple, small structures for simple small people. The trouble with that is that it introduces not only the possibility of being wrong in many, many unnecessary ways, but also if you are not wrong, you know that you cannot have over, say back in 1958, ten stockholders and now a hundred. But you have that 101st stockholder and you suddenly are disqualified. You are disqualified because you have too many. Well, why too many?

You mentioned benefits of S corps. What we are talking about detriments. The benefits go to a pass through entity, not nec-

essarily an S corp, a partnership, an LLC that is not subject to any of these limitations that we are talking.

You asked who might oppose relief from the limitations. The fact is my former Department of Treasury has opposed relieving S corp restrictions. Why? Because let us go back to the simple structures for simple people. They think that if you relieve S corps of some of these limitations, that we at this witness table have brought out, you suddenly are creating a problem for the economy, for IRS and for S corps because S corps suddenly get complicated. Oh, no, it does not make any sense whatever. If you look at the regulations under Section 701 code, and I hate to mention code numbers but I have got to here, you find that they tell you how to get that 101st stockholder and they tell you how to get the nonresident stockholder. What you do is you have your S corp join in a partnership with the excess stockholder or with the nonresident alien stockholder and suddenly that's okay. Well, that is not the way that mainstreet business should be conducted at all.

Chairman AKIN. More complicated than the other alternative?

Mr. ALEXANDER. It is much more complicated. And Treasury requires this complexity. Part of it is the fact that they like partnerships. They like LLCs; that is the wave of the future, that is the choice of today. So why should we do anything for S corps?

Chairman AKIN. So then the primary people that are opposed to change would be probably Treasury, would that be a fair assessment?

Mr. ALEXANDER. Well, there is another problem, too. Because any time that you do something good for S corps, the Joint Staff is going to put a big number on it and it is a revenue loss. And you got to figure out how to get some revenue to pay for that revenue loss under the PAYGO rules and whether under the current rules you still have to pick up that revenue, I do not know. But the other side of it is that the bills that you have heard about, and particularly Mr. Shaw and Mr. Ramstad's bill 4421 would do a lot to try to get rid of some of these shackles. But it might be expensive to do it.

Chairman AKIN. All right. Well, I would love to ask some more questions, but my five minutes has expired and I need to go to the fair lady from Guam.

Ms. BORDALLO. Thank you, Mr. Chairman.

I have a question for Mr. Sullivan. How much of a competitive disadvantage are S corp operating at if they continue to be prohibited from seeking to sell stock to individual retirement accounts and nonresident aliens, and would these sources of capital be significant? And if so, how would they compare to the sources of capita that currently exist for S corp?

Mr. SULLIVAN. Congresswoman, I do not know the dollars and the equations that would lead up to an exact figure to say this is the competitive disadvantage. What we do see is that without the reforms allowed in Mr. Shaw's bill that would allow for a preferred stock, for instance, for succession planning and so forth. What we do see is a modernization of S corp structures. And I guess the easiest way to answer the competitiveness question is that we really do not want to get to a point where all of a sudden we wake up and say "Oops, we are at such a severe disadvantage that S corps

are trapped and they are not able to elect out of the status without paying an enormous toll." We do not want to reach that point.

And what we do see is that as the economy has evolved, the rules that were originally in place that would prohibit a nonresident alien ownership or different classes of stock really no longer apply in this marketplace. And so the reform is not only a competitiveness issue but also a modernization issue.

Ms. BORDALLO. Are there any other witnesses that would like to answer that question?

Mr. REDPATH. I do not know the answer to that question, but what I do see in my practice, you know I work in the trenches applying these laws to hundreds of S corporations. And what we do see is that our S corps' competitors are organizing as LLCs. And those competitors are not just domestic, they are international. And they are not subject to these restrictions.

You know, one of the answers to the other question is my clients ask me the same question all the time. You know, why are we limited to certain number of shareholders? Why are we limited to a certain class of stock? You know, why are we—things like that. And we do not have an answer because they ask us, the LLCs are not and those are their competitors.

So I see the competitive disadvantage. I obviously don't have the numbers that they were asking for.

Ms. BORDALLO. I would like to ask Mr. Porcaro.

Mr. PORCARO. Yes, ma'am. Well, that same question?

Ms. BORDALLO. Yes.

Mr. PORCARO. Again, it is hard to quantify. The only aspect I can see is that with regard to IRAs, in particular, the issue of whether the IRA funds can be utilized in some form or another to invest in S corporations has come up several times over the years. So there is definitely a large pocket of resources tied up in IRAs that potentially could be used as the alternative source of capital.

With regard to the international implications, in every situation where we had such a scenario, we have had to utilize LLCs in order to bring in any international capital. S corps just do not provide a mechanism for doing that. And that is, I guess, the way that situation is and how much more we would be able to do with S corps, I am sure there is a substantial amount. Because even in a firm my size we see more and more globalization of business activities even in smaller businesses.

Ms. BORDALLO. Mr. Alexander, would you like to put in your two cents?

Mr. ALEXANDER. Yes. Into a mike that works.

Yes, my two cents. I agree with the statements of the other witnesses. And S corps, although the largest single number of business entities in this country, have not yet reached zero population growth, but they are almost there. Thanks to the fact that LLCs has been discussed coupled with the check-the-box rules that Treasury happily put out have created such a competitive tax environment as to greatly disadvantage the S corp to such an extent—did I do that?

Chairman AKIN. Well, that was a nonpaid advertisement. Go ahead.

Mr. ALEXANDER. We are a little distance from the Hart Building anyway. That is good.

I was saying that the S corp now almost has a zero population growth. There are still a lot of them. Why are there a lot of them? Because getting out of them is so expensive, as the witnesses have pointed out.

Maybe they will tell us again.

Anyway, back to S corp. New S corps, in my experience anyway which is limited, of course, are not being created if the would be entrepreneur, the new business person has a choice. The far, far superior choice is the limited liability company or sometimes the ancient partnership where you are not subject to any of the limitations that we have described and where you have tax nirvana, S corps are far from that and they need not be.

Ms. BORDALLO. Thank you. Thank you very much.

I have one other question, kind of a follow-up. Since you do not have the numbers, do you have studies or analysis that pertain to the value of the S corporation format that you would call to the Committee's attention? Any of you could answer that.

Mr. PORCARO. I do not know of one.

Ms. BORDALLO. None of you?

Mr. SULLIVAN. Congresswoman, in my testimony we do point out the economic benefits of S corps and the volume and number of those S corps are really tremendous. And I think what Don Alexander was pointing out is that if you have a choice in the future, it is likely that you will not choose S corps. But the numbers are so large for existing S corps that to ignore the need to modernize it will be devastating to the economy.

Ms. BORDALLO. Would SBA have any of this information?

Mr. SULLIVAN. We do have information about the economic value of S corps. We also have information about the disproportionate regulatory burden on small business, but we don't segment out the disadvantage competitively of S corps versus other small business.

Ms. BORDALLO. And, Mr. Sullivan, I think you were—or I am sorry, Mr. Alexander?

Mr. ALEXANDER. I believe that there are some studies that could be helpful, although perhaps not exactly in point in your excellent question. I think the GAO has studied S corps, although not as recently as all of us would like. But Joint Committee on Taxation has also studies the S corp situation although sometimes they are not as concerned about these limitations as we at this table would hope that it would be.

Ms. BORDALLO. Thank you. Thank you very much.

Mr. Chairman.

Chairman AKIN. Thank you. Let me ask a radical question. What would happen if we just said we are going to get rid of S corps and let everybody that has an S corp convert over to LLC with no penalties, no review of back taxes? Just say if you want to shift over, you can just go from one to the other. First of all, is that a radical idea? Would that be hard to do politically or financially, or how would that work? Would that make sense to do? Is there anything in an S corp that an LLC doesn't have?

Mr. ALEXANDER. Well, there are certain things for banks that an LLC does not have because a bank by law, as I understand it, has

to operate as a corporation. So you would have to, I think, change the rules.

Chairman AKIN. You would have to deal with something relative to banks? It would be smaller banks then?

Mr. ALEXANDER. Yes. I think the banks, small banks would need to have sort of a special rule. A federal law could of course override or a federal law could replace that restriction. Because I think it is in federal laws, perhaps in state law. But apart from that, and I would like to hear the people that actually deal with this situation on the ground, but I think as far as I am concerned if there were no toll charge on moving from S to the faxed favored entity, LLC, I would strongly recommend that all the S corporations that I represent immediately move.

Mr. REDPATH. A couple of comments I have. And one would be relating to ESOPs and ESOPs owning S corporations. And there are many S corporations that have ESOPs as shareholders. And ESOPs, you know, currently could not be sponsored by partnerships or LLCs. So we would have to deal with that as an issue.

The other thing is just applying the partnership rules to corporate structure may be difficult. There are a variety of different rules in the partnership area relating to the allocation of income, the allocation of debt, calculation of basis; many things in the partnership area which LLCs are taxed under. That would need to be addressed to determine how they be allocated at the corporate world.

My personal opinion is these fixes that are proposed by H.R. 4431 and 1239 go a long way to helping the S corporation. They really do. I believe that many of my clients, given the option to convert to an LLC or if these rules may stay as an LLC just because of some of the things I just mentioned.

Chairman AKIN. In other words, there is a conversion cost just because you are doing some things a different way?

Mr. REDPATH. There is a conversion cost and there is the application of the tax law itself. Just simply indicating that a corporation now would be taxed as a partnership, there are many things that need to be addressed under the partnership tax regime as to how that applies to a corporation.

Chairman AKIN. If somebody wanted to do that, could that be defined before such a conversion were made? If you talk about simplification, which you know to some degree, simplification is a good thing. The LLCs are working pretty well, is there really a need to keep the S corps around? I am not opposed to making the modernizations, but I guess that was my question: Why do we really have two things doing the same job in a way?

Mr. PORCARO. I would like to make a comment relative to what Mr. Redpath said or to emphasize it. The application to tax law for partnerships is substantially complicated than Subchapter S. And what I have found and people have converted or utilized LLCs without the proper guidance, have actually got themselves in the situation they did not anticipate. Contribution of property to partnerships, for example, carry with them a toll of up to seven years depending upon how that property is dealt with, either by sale or distribution.

So there are reasons why Subchapter K works and there are reasons why Subchapter S works. So I have never really felt that I think there was a proposal was to do just that, make like either a smaller no-tolled charge to convert and just merge everything to Subchapter K. I believe the reason why we have the different subchapters is because they all do different things. And in certain circumstances the S corp is the way that a business should be functioning and in certain circumstances the LLC definitely has some aspects to it that are beneficial. And I do not know if we could sufficiently bridge the tax application and compliance from Subchapter K to S without more than just a nominal cost, outside of revenue costs. I mean just an administrative cost for taxpayers in general.

It is not as simple, I guess, is the way I see it, as all that.

Chairman AKIN. I guess my question is one of the things that was argued when we cut capital gains and things was that when we create all these complicated tax rules, what we are starting to do is we are starting to force some corporate structure into some pattern which may not be economically the most efficient way to run the business. So that the more transparent that we can make the tax code, it gives the people that run the businesses the flexibility to be as productive as possible. And when we tie up all kinds of resources because if you touch this, you are going to get zapped with taxes on it, we basically have all this money sitting around which could be invested in a better way. So at least the concept that I subscribe to and that I think a lot of people have talked about is that when you back your tax code off and make it less specific so that people have flexibility to properly manage their resources, otherwise, people will not make the most appropriate investments. It just makes us more productive and more competitive. And clearly we are in an increasingly global environment where competition is critical that we are competitive. So, that was why I was asking that question.

We have been joined by a fantastic Congresswoman from the great State of New York. And would Ms. Kelly want to make a question or comment?

Ms. KELLY. Thank you. I appreciate your turning to me.

I will just make a comment that I have started several Subchapter S corporations. And for the people who are just entering a small business who need the corporate shield which a Subchapter S, and I am talking about liability here, when you are looking for that liability corporate shield if you are true very small business, a Subchapter S is a very easy and economical way to get into a corporate position. It's not an impervious veil, but it is certainly something that does help. And I am concerned about changing some status.

For instance, the single taxation status, I would be interested in your view on whether or not you think that ought to be changed.

Limited shareholders, I would be interested in what you think about that.

And I am very concerned about the liability protection. Liability protection is one of the most common reasons that people who start small businesses go into any kind of a corporate structure. You do not have to be a corporation to do business in this country. And so

I would be interested to hear you address those couple of issues: Liability protection and single taxation and the shareholder limitations. And I wonder if I could just start maybe with you, Mr. Porcaro, and move this direction down.

Mr. PORCARO. Well, with regard to single taxation, are you referring to just the pass through structure that we have now?

Ms. KELLY. Yes.

Mr. PORCARO. Well, it has been experience that that is a very efficient way to deal with the small business environment where many times the complication of a corporate structure are not always adhered to, and the manner of that would be in a larger entity. And so there is not always a fine line in the small business owner's mind as to the corporate pocketbook versus their own So in many cases having this ability to have this pass through limits their exposure to a tax liability they may not have had. It is basically all going to be taxed at one level. And if they erroneously classify an item, whether it should have been personal or business related, it will flow to them and they will pay that one tax because that is how it should have been in the first place.

With regard to the limited number of shareholders, to be frank with you in my particular practice the current limitation of a 100 shareholders has been more than adequate. We do not have any S corporations with more than 10.

And I just looked at some Internal Revenue Service statistics, and there are not that many S corporations with more than 50.

So I do not know—and now with the single family, the family election which can bring in multiple generations, I do not see that as being a real restriction as it used to be. The steps that have been taken have been tremendous in helping avoid that problem in my experience.

And the liability issue, I cannot really comment on not being an attorney because I have attorneys tell me that in some respects the LLC provides better liability protection depending on the state in which you are organized in than a corporation might. So I do not know if that is true.

I know in Rhode Island the jury is really kind of still out because we have not had a case that has challenged the limited liability protection of an LLC.

Ms. KELLY. Thank you.

Mr. PORCARO. You are welcome.

Ms. KELLY. Mr. Redpath?

Mr. REDPATH. Yes. Thank you.

Single taxation is how we create virtually all new entities, small closely held businesses, whether we use an LLC or an S corporation; either one does that. It is a benefit of both and that is something that I believe just needs to be there for the small business to compete.

Rarely do we ever create a S Corporation subject to double taxation.

The number of shareholders, you know, is an issue that as Mr. Alexander pointed out people get around that. They get around that by creating partnerships with S corps as partners. And so there are ways to increase the number of shareholders with S corporations.

What we are more interested in is the classes of shareholders and the types of shareholders. And allowing S corporations to benefit the same as LLCs with regards to who can own the stock and what your ownership rights are.

With respect to a LLC and a corporation, I agree with you, a corporate entity structure has been around much longer, much simpler. If you read an LLC operating agreement or member control agreement, it is a very complicated document. When you read corporate bylaws, you can actually maybe understand them. So I agree with you from that standpoint.

Ms. KELLY. Thank you.

Mr. Alexander?

Mr. ALEXANDER. My two cents again.

First, on the issue you raised on limited liability. I agree with Mr. Redpath, that is absolutely essential. Absolutely essential. And you have that in an LLC form in all the states that have adopted them. And I think all the states have at this point. You have it also in an S corp and you have it in a C corp. But why on earth would anyone use the C corp at least at the beginning of a business organization's life? No one.

Single tax? Sure.

Number of shareholders. I was interested to hear those that actually work more than I do in this area that a 100 is sufficient. I have heard from the community bankers that a 100 is great, but that more would be better.

We do look back six generations now to find all the members of the family going back to a single ancestor six back treated as one shareholder. Think about that. You can sure bring in a lot of shareholders that way if you have a big family. So maybe the 100 shareholder limit does not create a real problem except in the very limited area of community banks. But it surely creates a huge problem when you are talking about the types of shareholders; nonresident aliens forbidden except through the mechanism that we have discussed of a partnership and an S corporation getting together.

And of preferred stock, no mezzanine capital. That limitation never made much sense, but somehow Treasury thought it was appropriate. Why? I do not know, but maybe Mr. Sullivan can say what the Department was doing?

Mr. SULLIVAN. Congresswoman Kelly, first of all on your question of limiting liability, I think actually that questions extends even far beyond the tax code. And I commend the Small Business Committee in the House particularly for continuing to push small business liability relief because it is a huge issue and transcends little different parts of the tax code into an overall threat and drag on the small businesses economy. So I echo the detailed tax related comments, but then also urge the Committee not to let up in your push for small business liability reform overall.

You asked about expanded shareholders. I would defer really to this distinguished panel. And I think what has come out of this hearing is that the shareholder requirements of Subchapter S do need to be modernized, whether that be different classes of shareholders that Mr. Redpath mentioned or an expansion as Don Alexander talked about related specifically to community banks.

The single tax system, and actually in the President's Commission on Tax Reform that was one area that they encouraged policymakers to look at and Subchapter S certainly prioritizes the single tax system. And for that reason I join the President's Commission and actually echo their recommendations that you do focus in on the single tax systems and enhance ways to make that even better through Subchapter S.

Ms. KELLY. Thank you.

That single tax system, as Mr. Redpath pointed out, sometimes it's a very, very blurred lined. An rather than set up an impossible rule that we cannot enforce or that is going to put a chill factor on our ability to form Subchapter S and appropriately pay the taxes, it is far better to have that line clear, defined and single I think. So I appreciate your comments on that.

And I am sure that my time must be up, so I will yield back.

Mr. AKIN. Well, we are pretty good shape on time. I promised we would get out of here in about an hour, and I think we are pretty close to that. So things are working out.

Anybody want to ask one more? Yes.

Ms. BORDALLO. I would like to ask this of Mr. Alexander. He seems to have such a long history on this subject.

Do you expect that there is a significant tax gap? I know this was brought up earlier, but I do not remember really what the answer was, for filings from S corporations? And what do you believe the Internal Revenue Service will do in response if there is a significant tax gap for S corporations? What should American small business owners be expecting here?

Mr. ALEXANDER. Commissioner Everson is enforcing the law. The tax law was not enforced very well and very effectively, efficiently or fairly a few years ago. The problem is that IRS may be overdoing it a bit and Mr. Sullivan indicated his concerns about that in the S corporation field.

Pass through entities do present a problem for the tax collector, and I used to be a tax collector. However, the fact that the problem is presented to the tax collector doesn't mean that the tax collector should not be fair and reasonable. But the tax collector needs to be thorough because we do have a very large tax gap in this country. The IRS estimate is about $300 billion yearly after taking into account—after netting out what the IRS will likely collect from those who had not made their full and proper contribution. Actually, the gap is a lot bigger than that because that includes only the legal sector and only part of the types of taxes that we impose in this country. For example, the estate tax "gap", whatever it may be, is not included in IRS' figure.

If the laws were fully effective, our tax laws produced what they should produce, we would not have a deficit at this time. But you cannot make that happen in a democracy. There is bound to be some slippage, and there should be some because otherwise IRS' is bearing down on some people very hard indeed while missing others, particularly in the legal sector that, let us say, do not rush forward to pay their taxes on money that they obtained illegally in the first place.

There is a problem. There is a problem in small business, regrettably. But largely in the businesses that deal in cash. If the busi-

ness finds, and perhaps this does not rise to the level of calling something like that a business, that cash is the way that it handles its transactions, it is very unlikely to share with the tax collector the amount that should be paid.

Ms. BORDALLO. Thank you. Thank you very much.

Thank you, Mr. Chairman. No further questions.

Chairman AKIN. With no further questions, with thanks to our witnesses, the Committee stands adjourned.

[Whereupon, at 11:15 a.m., the Subcommittee was adjourned.]

Opening Statement
June 27, 2006
Regulatory Reform and Oversight Subcommittee
House Committee on Small Business
W. Todd Akin, Chairman

Good morning and welcome to today's hearing entitled "S Corporations – Their History and Challenges." I want to especially thank the witnesses for taking time out of their busy day to participate at this important hearing.

We are here today to explore a very important business structure that has helped to foster an entrepreneurial environment since the late 1950's. Prior to the development of this corporate structure, entrepreneurs had two options in creating a business entity. They could form a partnership, which would allow for a single layer of tax on profits, but expose an entrepreneur to high levels of risk. Or, they could form a C corporation, which would shield the entrepreneur from excess risk, but create a double layer of tax on profits.

Neither business structure adequately addressed the needs of entrepreneurs and so in 1958 Congress and President Eisenhower acted to create the S corporation. The S corporation allows for limited liability and a single layer of taxation for small closely held businesses. The adoption of subchapter S was a huge step forward in encouraging small and family-owned businesses in America.

Today, S corporations are the most popular corporate entity. The IRS estimates that there were 3.2 million S corporation owners in the United States in 2003 – compared to approximately 2.1 million C corporations and 2.3 million LLCs and other partnerships. But while the S corporation community has grown and matured, the rules governing S corporations have remained largely the same. The number of shareholders is still limited, an S Corporation may have only a single class of stock, and the rules still limit who or what may own shares in an S corporation.

Today we will hear testimony expounding on:

- The history of S corporations and the role they have played in encouraging the rise of small and closely-held businesses and in the U.S. economy;
- The unique challenges S corporations face with the rules governing subchapter S;
- Legislative proposals to modernize the S corporation structure; and
- IRS National Research Program study of S corporations.

I look forward to learning more about how S corporations benefit the American entrepreneur and what more can be done to aid this important component of the U.S. economy. I now yield to the gentlelady from Guam, Madame Bordallo.

Congresswoman Madeleine Z. Bordallo
Opening Statement
House Small Business Committee Subcommittee on
Regulations and Oversight
Hearing titled, "S Corporations – their History and Challenges"
Tuesday, June 27, 2006

Thank you Mr. Chairman.

Small businesses drive our economy. It is critical that our country's small businesses remain strong and vibrant. It is this Committee's responsibility to facilitate achieving that goal in any way that we can. Reviewing the benefits of and potential modifications to the S- Corporation business model is important to our nation's small businesses, as many of them are indeed S- corporations. Legal and regulatory structures must reflect the pressures of modern business. They must be written in a way that does not put small business at a disadvantage. Our country's small businesses must be allowed to remain competitive in today's fast-paced marketplace.

The number of small businesses that have been organized as S Corporations has tripled from around 1 million to 3.25 million over the last 20 years.

Among other things, the S Corporation offers a number of appealing tax benefits and protections against personal liability.
For instance, the S Corporation classification allows entrepreneurs to avoid a "double tax" on their corporate and shareholder dividend earnings.

The S Corporation also provides a form of insulation for small businesses to be more confident in moving forward with their innovative ideas and ventures.

S Corporation classification is a proven way for small businesses to achieve the benefits of corporate ownership.

But there are still a number of barriers preventing S Corporations from reaching their full potential for growth.

I look forward to hearing today's discussion on how we can work to ensure that the S Corporations remain a strong and viable option for this nation's small businesses.

Thank you.

Advocacy: the voice of small business in government

Testimony of

The Honorable Thomas M. Sullivan
Chief Counsel for Advocacy
U.S. Small Business Administration

U.S. House of Representatives
Committee on Small Business
Subcommittee on Regulatory Reform and Oversight

Date:	June 27, 2006
Time:	10:00 A.M.
Location:	Room 2360 Rayburn House Office Building Washington, D.C.
Topic:	S Corporations – Their History and Challenges

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit ***http://www.sba.gov/advo****, or call (202) 205-6533.*

Good morning Chairman Akin and Members of the Subcommittee, I thank you for this opportunity to appear before you today. My name is Thomas M. Sullivan, and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). The Committee invited me here today to discuss the importance of S-corporations in the U.S. economy, recent legislative proposals, and the Internal Revenue Service's (IRS) audit study of S-corporations.

Congress established the Office of Advocacy (Advocacy) to represent the views of small business before Congress and Federal agencies. The Office of Advocacy is an independent office within the SBA, and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. This statement was not circulated to the Office of Management and Budget (OMB) for comment. Advocacy takes its direction from small businesses, therefore this statement is based on the interests and concerns communicated to us by small business groups.

Small Business and the U.S. Economy

Small businesses are a driving force in the U.S. economy. They comprise 99.7 percent of all employer firms in the U.S., employ half of all the private sector workers, and have generated 60 to 80 percent of the net new jobs annually over the last decade.[1] Small firms pay 45 percent of the total U.S. private payroll, and create about half of the non-farm private gross domestic product.[2] Small businesses also tend to innovate at a higher rate than medium or large businesses,[3] producing 13 to 14 times more patents per employee.[4] Furthermore, small firm patents are more likely to be driven by leading-edge technology than large firm patents.[5] Finally, during economic downturns, small businesses fare better than their larger counterparts. Increases in small business employment and self-employment often help steer the economy out of recessions.

Just as small businesses are the cornerstone of the U.S. economy, S-corporations are the cornerstone of the small business economy. According to IRS Statistics of Income for tax year 2002 there were approximately 3.1 million S-corporation returns filed, making up 59.6 percent of all corporate returns. S-corporations generated $3.9 trillion in annual revenue. According to the Bureau of Census 1997 statistics, S-corporations are the second largest employer, employing approximately 21 million Americans.[6]

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[1] Frequently Asked Questions, Office of Advocacy, U.S. Small Business Administration, 2006, available at http://www.sba.gov/advo/stats/sbfaq.pdf.

[2] Joel Popkin and Company, *Small Business Share of NAICS Industries*, study funded by the Office of Advocacy, U.S. Small Business Administration (2002), available at http://www.sba.gov/advo/research/rs218tot.pdf.

[3] U.S. Small Business Administration, *The State of Small Business: A Report to the President* (2005).

[4] CHI Research, Inc., *Small Serial Innovators: The Small Firm Contribution to Technical Change*, study funded by the Office of Advocacy, U.S. Small Business Administration (2003), available at www.sba.gov/advo/research/rs225tot.pdf.

[5] *Id.*

[6] Table 7. Statistics for All U.S. Firms by Major Industry Group and Legal Form of Organization: 1997. This is the most recent data available. Data for 2002 is expected to be released before the end of the year.

Proposed Legislation – H.R. 4421

S-corporations were created in 1958. They were developed to enhance entrepreneurial activity and to eliminate the negative effects of double taxation experienced by taxable corporations (C-corporations).[7] C-corporations are subject to double taxation because the corporation itself is liable for income tax on its earnings, then when dividends are distributed to the shareholders the shareholders must pay income tax on those dividends. To receive favorable tax treatment, entities electing S status must adhere to many restrictions, including:

- the number of shareholders,
- type of shareholder,
- class of stock and
- domesticity requirements for S-corporation elections.

In the half century since the creation of S-corporations, the U.S economy and the world's economies have changed. With the advent of technology, globalization of the economy has become more of a reality. Policymakers considering changes to tax policy must take a broader view that includes tax policies around the world. To ensure America's entrepreneurs remain competitive, in a global marketplace, we must adopt tax policies that remove barriers to their success.

S-corporations are a large segment of the U.S. economy. To ensure their continued success H.R. 4421, the "*S Corporation Reform Act of 2005*," was introduced by Congressmen Clay Shaw and Jim Ramstad. The legislation is intended to reform the provisions that control S-corporations so that S-corporations can reach their full potential. H.R. 4421 contains provisions that are advocated and supported by the American Institute of Certified Public Accountants and others.

Take the Sting out of the Sting Tax

Current law penalizes S-corporations if they earn too much passive investment income (this rule is commonly known as the "sting tax").[8] Specifically, if an S-corporation that previously was a C-corporation has undistributed dividends, and earns 25 percent of its gross receipts as passive investment income, then two things will happen. First, the S-corporation is taxed on its income at the highest corporate rate. Second, if the S-corporation earns too much passive investment income for three consecutive years, then the S election is terminated all together. The result is that the S-corporation becomes subject to double taxation. Double taxation is the penalty for earning too much of the wrong type of income (i.e. passive investment income) and/or earning that income too often, thus eliminating the purpose for electing S status.

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[7] Other legal forms of taxpayers that are subject to a single layer of tax, such as partnerships and limited liability companies, are commonly known as passthrough entities. Generally, this means that the entity itself is not taxed on its earnings, but the owners of the entity must report the earnings on their personal income tax return.

[8] Internal Revenue Code section 1362(d)(3)(C) defines passive investment income as receipts derived from rents, royalties, dividends, interest, annuities and gains from the sale of stock or securities.

The sting tax is out of step with today's tax provisions. Tax policy has been moving away from double taxation and toward a system of single taxation. C-corporations which are subject to double taxation have not been growing as rapidly as entities that are not subject to a single layer of tax (theses entities are commonly known as passthrough entities).[9] The sting tax was created to mirror rules that applied to C-corporations that were personal holding companies (PHC). PHCs are no longer prohibited from generating passive investment income from gain on the sale of stock or securities. Additionally, PHCs are permitted to earn up to 60 percent of their gross revenue as passive investment income. The sting tax does not affect other passthrough entities, such as partnerships and limited liability companies. This puts S-corporations at a competitive disadvantage with other passthrough entities. S-corporations that were previously C-corporations should not suffer harsher treatment simply because they earn the wrong type of income. H.R. 4421 seeks to remedy this inequity by reforming the sting tax.

In addition to the disparate treatment S-corporations receive as compared to PHCs, the sting tax has other negative effects. Small and family-owned businesses are often not aware of the sting tax. Thus, the sting tax punishes the unwary. Small business owners have many laws and regulations to be aware of as they conduct their business. Our tax code should not set up traps for the unwary.

All These Restrictions – How Can We Grow?

Under current law, S-corporations can have only one class of stock, debt can not be converted to stock, and shareholders can neither be a nonresident alien nor an individual retirements account (IRA). In today's business environment, these restrictions build unique barriers for planning for the future of the family business, and restrict the S-corporation's access to capital. H.R. 4421 would remove these restrictions.

It is common to plan for the next generation of leadership of a family business, by issuing preferred shares to the generation that is leaving the business as a means to provide for their retirement and their orderly withdrawal from the enterprise. However, because S-corporations may not have more than one class of stock, this practice is prohibited. Thus, family owned businesses must incur additional expense to ensure that the retiring generation is provided for. Prohibiting nonresident aliens and IRAs from being shareholders adds to the complicated planning. H.R. 4421 would allow S-corporations to issue qualified preferred stock which will enhance succession planning for many small family-owned businesses.

America's families are changing. It is not uncommon for today's American family to include nonresident aliens. When an S-corporation's related shareholders include a nonresident alien, it faces additional planning to ensure that the nonresident alien is provided for and that the S election is not violated. Both chambers of Congress are working diligently to take the bite out of estate planning; the reforms in H.R. 4421 enhance those efforts.

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[9] IRS Statistics of Income; S Corporation Returns, 2002 (from 1986 to 2002 C-corporation returns have declined on average 1.3 percent annually).

H.R. 4421 recognizes the need to enhance the growth potential for S-corporations by removing outdated restrictions. Provisions of H.R. 4421 would remove the limit on one class of stock, the prohibition against debt convertible to stock, and would permit nonresident aliens and IRAs to be shareholders of an S-corporation. Together these provisions decrease the complexity of planning for the future of the small family business and increase the growth potential of S-corporations by removing barriers to access to capital.

Everyone Makes Mistakes

To have a valid S election the electing corporation and its shareholders must take the necessary steps to perfect or complete the election within a specified period of time. If the election is not timely completed or is defective, the Treasury Secretary may excuse the imperfection if the electing corporation and its shareholders take the necessary steps to ensure the S election requirements are met. Obtaining an excuse for an imperfect election is not guaranteed. Additionally, the time period that is covered by the excuse is not certain. H.R. 4421 recognizes that not every taxpayer is savvy, nor represented by sophisticated tax counsel. The bill provides additional protection for invalid elections or terminations of an S election. Specifically, H.R. 4421 permits the Treasury Secretary to extend the excuse for an invalid election or inadvertent termination of an election for a period of time that covers tax years for which a refund or credit has not expired.

The importance of this protection is amplified when there is an attempted acquisition of an S-corporation. Acquiring a business requires a high degree of due diligence. One area that must be investigated when attempting to acquire an S-corporation is whether the S election has always been valid. Without this assurance, an acquirer takes the risk that the rules against passive investment income (and other rules) may increase the cost of their investment. Having the assurance that an inadvertent violation of the S rules is not fatal to the S election will limit the risk a potential acquirer must consider when purchasing an S-corporation.

IRS National Research Program (NRP)

In February 2006, the IRS announced the results of its tax year 2001 NRP study of high wealth individuals and small businesses that file Schedule C. The results of the NRP indicate that there is a net tax gap of approximately $290 billion.[10] The tax gap is defined as the difference between what taxpayers owe and pay on time and what actually gets paid on a timely basis. The net tax gap is the remaining gap after IRS enforcement actions and other late payments are made. The IRS reported the study results and attributed the majority of the tax gap to small businesses which file Schedule C, despite not having updated data on other types of taxpayers such as partnerships and C-corporations.

On July 25, 2005, the IRS announced its plans to conduct an NRP compliance audit study of 5,000 S-corporation returns from tax years 2003 and 2004. Commissioner Mark Everson justified this new study based on the fact that the number of S-corporations

[10] *IRS Updates Tax Gap Estimates*, 2006 TNT 31-6 (February 15, 2006).

has grown between 1985 and 2002 from approximately 724,000 corporations to about 3.1 million corporations. S-corporations only account for approximately 19 percent of corporate revenue.[11] Along with auditing the S-corporation returns, the IRS plans to audit all returns of S-corporation shareholders with 20 percent or more ownership interest in the corporation under audit. The small business community is concerned they are the only sector that is being subjected to an in-depth audit study. The Office of Advocacy shares small business' concerns.

America's small businesses succeed because of their ingenuity and innovation. Research sponsored by Advocacy continues to show that the cost of tax compliance is 67 percent higher in small firms than in large firms.[12] Facing an audit increases the costs of tax compliance by requiring business owners to incur the expense of representation and it takes time away from their business to answer IRS inquiries. Small businesses take their responsibility to pay their fair share of taxes seriously. No one wants to defend those that deliberately cheat the system. However, IRS' approach may punish those that voluntarily comply with the law, based on the failures of those that do not.

In summary, small businesses have a long history of contributing greatly to the American economy. S-corporations play a critical role in keeping the economy strong. To ensure their continued success, government has to be wary of taking steps that may stifle the entrepreneurial growth of S-corporations. Legislation introduced to reform S-corporation provisions should be based on tax policy that enhances entrepreneurial competitiveness H.R. 4421 accomplishes this. As the IRS strengthens tax compliance efforts, attention should be given to why taxpayers become noncompliant so that recommendations are tailored to meet those challenges.

Thank you for allowing me to present these views. I am happy to answer any questions.

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[11] Id. note 9.

[12] *The Impact of Regulatory Costs on Small Firms*, Crain, W. M., September 2005, U.S. Small Business Administration, Office of Advocacy (SBHQ-03-M-0522), available at http://www.sba.gov/advo/research/rs264tot.pdf (tax compliance cost large firms $780 per employee).

STATEMENT OF DONALD C. ALEXANDER
OF AKIN GUMP STRAUSS HAUER & FELD LLP
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON REGULATORY REFORM AND OVERSIGHT
JUNE 27, 2006

My topic is primarily the history of S corporations and the changing rules applied to them over the years but also the need for further relief.[1] First, I wish to congratulate this Committee upon its interest in, and concern about, Subchapter S corporations and the tax rules and restrictions applicable to them. Subchapter S was enacted in 1958 under the Small Business Tax Revision Act, and over 40 years later the S corporation form remains an important business model in the United States. In 2003, the IRS received returns from 3,341,606 Subchapter S corporations. The total net income from S corporations in 2002 was $183.5 billion and total assets of these corporations was $2,186.6 billion in 2003. Subchapter S remains an important part of small business taxation in America.

I. History of Subchapter S: Adoption and Evolution

Before the adoption of Subchapter S, all corporations, whether public or closely-held, operated under the double taxation of earnings system. Partnerships, on the other hand, were taxed on a pass-through system that insulated these entities from double taxation. A 1946 publication by the Treasury entitled "The Postwar Corporation Tax Structure," authored by Dr. Richard B. Goode, suggested taxing closely-held corporations under the partnership model. The system suggested by this article bears some close resemblances to the Subchapter S that Congress adopted in 1958. Goode asserted that closely-held corporations were simply chartered partnerships, and should be treated differently than public corporations. Goode argued that in a closely-held corporation the distinction between shareholder and corporate income lacked economic reality because shareholders of closely-held corporations had effective control over dividend policy. Goode's suggested pass-through taxation system required the allocation of undistributed profits to shareholders on some fixed date, such as the end of the corporation's accounting period—which was the regime codified in former Section 1373(b) prior to 1982.

In the five years preceding 1950, U.S. small businesses did not fare well in the U.S. economy. Over that period of time and into the 1950s, the highest marginal tax rate for corporations ranged from 42% to 53%, while the highest rate at which individuals were taxed ranged from 82% to 91%. The double taxation system put a particular strain on small businesses, and there were strong incentives for small business owners to remove profits from their businesses only as compensation. This practical limitation was not suitable for all owners, of course.

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[1] Particularly on the history of Subchapter S, this statement relies substantially upon Eustice and Kuntz, *Federal Income Taxation of S corporations.*

In 1954, President Eisenhower proposed that closely-held corporations with a small number of active shareholders should have the option of being taxed as partnerships. The Senate adopted this proposal, but it failed to survive the Conference Committee. This first proposal would have allowed only new corporations to be taxed as partnerships so as to avoid the problem of corporations with accumulated earnings and profits bypassing standard dividend consequences on distributions.

In 1958, President Eisenhower again made recommendations to Congress for tax provisions to aid small businesses. These recommendations, along with Treasury-drafted provisions, developed into Subchapter S which Congress ultimately adopted in the Technical Amendments Act of 1958 under the Small Business Tax Revision Act. The reasons for the enactment of Subchapter S were spelled out in the Senate Report No. 1983 (July 28, 1958) as follows:

> **Section 68—election of certain small-business corporations**
>
> In 1954, Congress enacted legislation permitting proprietorships and partnerships to elect to be taxed like corporations (sec. 1361). At the same time, the Senate passed, but the Congress did not enact, a provision which would, at the election of the stockholders, permit corporations to forego the payment of any tax and require their shareholders to report the corporate income (whether or not distributed) as their own for tax purposes.
>
> Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence. In this respect, a provision to tax the income at the shareholder, rather than the corporate, level will complement the provision enacted in 1954 permitting proprietorships and partnerships to be taxed like corporations. Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business. It will be primarily beneficial to those individuals who have marginal tax rates below the 52-percent corporate rate (or 30-percent rate in the case of the smaller corporations) where the earnings are left in the business. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates since in this case a "double" tax is removed. The provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses. In this connection it should be noted that the President's Cabinet

> Committee on Small Business and the President in his budget message this last January recommended a general provision of this type for the benefit of small business.
>
> To permit shareholders in small-business corporations, in lieu of payment of the corporate tax, to elect to be taxed directly on the corporation's earnings, your committee has added a new subchapter (subch. S, secs. 1371-1377) to the code.

1958 *U.S. Code Congressional and Administrative News*, p. 4876 (1959).

Under the original version of Subchapter S, a corporation making the S election was never subject to income taxes. The undistributed income of the corporation was generally taxed as dividends to the shareholders of the electing corporation on the last day of the year. If the corporation had long-term capital gain, however, all or some of the dividends could be treated as long-term capital gain. Eligibility for the election was severely restricted in the 1958 version of Subchapter S by requirements that there could be no more than ten shareholders, only estates and individuals could be shareholders, and nonresident aliens could not be shareholders. Additionally, to be eligible for the election, a corporation could not have more than one class of stock, nor could it be a member of an affiliated group. All shareholders were required to consent to the election and the election had to be made during the first month of the corporation's taxable year or during the last month of the prior taxable year.

Subchapter S originally provided for five causes of termination: (1) the corporation could revoke its election with unanimous shareholder consent; (2) termination would occur if the S corporation ceased to meet the eligibility tests for a small business corporation; (3) termination would occur if a new shareholder failed to consent to the election; (4) termination would occur if over 80% of the gross receipts came from foreign sources and; (5) the election would terminate if over 20% of the gross receipts were from certain types of passive income.

Subchapter S did not stay in its 1958 form for long. While 1982 marked the major legislative overhaul of the Subchapter, significant changes had been made by Congress between 1958 and 1981. Many of the legislative changes after 1969 reflected proposals made by the Treasury in 1969.

In 1976 Congress increased the limit on the number of shareholders allowed for the S election from ten to fifteen under certain conditions, and then in 1978 allowed all electing corporations to have fifteen shareholders. This number was later increased to twenty-five, then thirty-five, then seventy-five, and finally 100 shareholders. A year after Subchapter S was adopted, Congress provided that a husband and wife be treated as one shareholder if they held the stock as joint tenants, tenants in common, or tenants by the entirety. In 1976 Congress further amended the Subchapter to allow the single shareholder rule to apply if the jointly held stock passed to the estate of one or both of the spouses, thus preventing death of one or both spouses from causing a termination in S status. However, until 1978, spouses were treated as two shareholders if they held the stock jointly and both individuals held stock. Congress changed the law in 1978 to apply the single shareholder rule to all spouses regardless of how they held their stock.

As to election restrictions, in 1976 Congress repealed the rule that a new shareholder had to affirmatively consent to the election, and replaced it with one that automatically continued S status unless a new shareholder affirmatively refused to consent. Furthermore, in 1978 Congress expanded the time for election. Voting trusts and grantor trusts became allowable shareholders. In 1966 Congress allowed an electing corporation to make nondividend distributions before paying out earnings and profits, a significant improvement.

In 1980 the Staff of the Joint Committee on Taxation recommended major changes to Subchapter S. These recommendations led to the increase in the number of permitted shareholders from fifteen to twenty-five in 1981 and to thirty-five in 1982.

The Subchapter S Revision Act of 1982 greatly improved Subchapter S by moving more towards the partnership model. Congress adopted the 1969 Treasury proposal allowing shares of stock to have different voting rights. Although Congress did not create a safe harbor for preferred stock, it did add one for straight debt—a closely-related concept. Extensive further changes made Subchapter S more usable by more small businesses.

Subchapter S also experienced significant change, a step backward, in 1986 with the repeal of the General Utilities doctrine; an S (like a C corporation) will almost always recognize gain on distribution of appreciated property.

The Small Business Job Protection Act of 1996 made further important changes in Subchapter S. The maximum number of shareholders was increased to seventy five, and certain wholly owned subsidiaries could be treated as pass-through entities.

In 2004 Congress further increased the number of shareholders allowed from seventy-five to 100, and provided that descendents of a common ancestor six generations back be treated as a single shareholder.

The evolution of Subchapter S has been substantial since its 1958 adoption. Gradual changes in the 1960s and 70s corrected certain defects and brought additional clarity, while the major overhaul of 1986 substantially changed the structure and administration of Subchapter S. Further developments in the late 1980s and 90s have refined and liberalized Subchapter S. Despite all of these changes, however, significant challenges for Subchapter S and small business S corporations remain, and further legislative relief is necessary.

II. Future of Subchapter S: Challenges and Opportunities

Some years ago Subchapter S corporations were the entity of choice if the owner of a small business wished to obtain the benefits of operating through the corporate form (limited liability) without suffering the detriment of double taxation on the business's earnings. However, after the Treasury's blessing of the limited liability company, plus the Treasury's adoption of check-the-box rules, partnership tax treatment (correctly called "tax nirvana") has been conferred upon nonpartnership entities. Limited liability companies are clearly preferable to Subchapter S corporations from the Federal tax standpoint; examples of favored treatment are the partnership basis rules (partner's basis includes partnership debt), liberal disproportionate allocation rules, and no limits on types of income and number or residence of owners. But some entities, like

banks, must conduct their businesses in corporate form, and others need to do so. These must use Subchapter S. Moreover, many Subchapter S corporations are locked in to elections made years ago; while they might now prefer to adopt the tax-favored partnership form, they cannot without a heavy tax toll charge. Subchapter S corporations are found on Main Street, not Wall Street. They are not asking for the famous "level playing field", i.e., the favored tax treatment granted to limited liability companies and partnerships. Instead, they are simply asking that some of the fetters imposed in another era be removed.

Some past Treasury tax policy officials, particularly those whose practice was concentrated on deal making through partnership "flexibility", have not been responsive to the proponents of Subchapter S reform. Among the reasons for opposition is the notion that while it is fine for partnerships to seek and obtain tax advantages through a sea of complexity, Subchapter S must be kept simple for simple people. But by confusing rigidity with simplicity, this notion itself creates complexity. Examples are the rules prohibiting a nonresident alien from being a stockholder in a Subchapter S corporation and limiting the number of Subchapter S stockholders. Example 2 of Reg. § 1.701-2(d) shows that a nonresident alien (or the 101st stockholder) can participate in a Subchapter S corporation's business by becoming a partner with the Subchapter S corporation. Why require this maneuver? Why not permit the nonresident alien, or the 101st stockholder, to come through the front door?

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

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

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

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

These simplifications should include, at least, the following:

1. S corporations should have access to senior equity by the issuance of preferred stock. Payments to owners of such stock or shares should be treated as an expense to the S corporation and ordinary income to the shareholders.

2. The number of S corporation eligible shareholders should be increased from 100 to 150, thus helping community banks to broaden their ownership and Subchapter S corporations to provide equity to key employees.

3. The current draconian rule that terminates S corporation status for corporations that have both subchapter C earnings and profits and that derive more than 25 percent of their gross receipts from passive sources for three consecutive years should be repealed.

4. Capital gains should be excluded from classification as passive income. Capital gains would be subject to a maximum 20 percent rate at the shareholder level, thus conforming to the general treatment of such gains as well as their treatment under the personal holding company rules.

5. Nonresident aliens should be permitted to own Subchapter S stock, subject to the limitations applicable to partnerships.

6. Subchapter S corporations should be permitted to issue convertible debt.

7. The provisions relating to qualified subsidiaries of Subchapter S corporation and relating to trusts permitted to own Subchapter S stock should be modified to make them more workable and useful.

Many of these improvements and others are present in the three bills reforming and revising Subchapter S that are currently before the Committee on Ways and Means. The most comprehensive is H.R. 4421 (S corporation Reform Act of 2005), proposed by Representatives Shaw and Ramstad, which would make a number of needed changes, including reducing from ten to seven years the period during which built-in gains of S corporations are taxed, permitting the issuance of preferred stock and convertible debt, allowing nonresident aliens and individual retirement accounts to hold S corporation stock, and allowing S corporations to receive 60% of gross receipts (up from the current 25%) from passive investment income without incurring additional tax. Representative Ramstad's bill, H.R. 2239, similarly would amend the Internal Revenue Code to reduce the period during which certain built-in gains of S corporations are subject to tax from ten years to seven years. Also, Mr. Shaw's bill, H.R. 4006, would allow certain startup S corporations and partnerships more flexibility in electing its taxable year. While all of these bills have merit, the broader the legislative action, the better.

S corporations operate in every business sector of every state. Typically, they are family-owned and operated businesses that have been reliable engines of job growth and productivity for the domestic economy. The rules adopted in 1958 when S corporations were created, even as subsequently amended, are out of sync with modern economic realities. S corporation reforms should address the troubling gap between the remaining restrictions enacted almost fifty years ago and the operating and capital needs of S corporations today.

Statement of
Jim Redpath, CPA
House Committee on Small Business
Subcommittee on Regulatory Reform and Oversight

"S Corporations – Their History and Challenges"

June 27, 2006

Chairman Akin, Ranking Member Bordallo and other members of the Subcommittee, thank you for the opportunity to testify today before the House Small Business Subcommittee on Regulatory Reform and Oversight.

My name is Jim Redpath. I am a certified public accountant and an officer at HLB Tautges Redpath, Ltd., a 100 person full-service accounting firm serving clients in the greater Minneapolis/St. Paul metropolitan area since 1971. We help more than 1,000 closely-held businesses make better decisions that create value and contribute to their financial well-being.

I want to thank you for holding this hearing to consider the state of S corporations and ways in which Congress can help them continue to be a vital part of the American economy.

I am here today speaking as someone who earns his living assisting companies on entity structure issues and creating new entities. My goal is to provide you with a first hand account of how the rules governing S corporations are outdated, and how those rules might be improved.

LLCs and S Corporations

Last year, our firm was involved in creating more than 100 business entities for clients. Of those, virtually all were LLCs and only a select few were S corporations. The advent of the LLC has created, in many cases, a superior business structure that should be considered as Congress reviews the rules governing S corporations.

When S corporations were created in 1958, they represented a shift in the tax treatment of closely-held businesses. The combination of limited liability with a single layer of tax was a significant improvement for closely-held businesses. These benefits of S corporations were limited to small and simple business structures. Today, the same rules apply in a much different business environment. S corporations have to be domestic entities; the number of shareholders is limited; the type of shareholders is restricted; and only one class of stock is allowed. Failure to comply with those rules results in loss of S corporation status and unexpected double taxation.

In contrast, the LLC was created in a different environment entirely. Their introduction and development between 1977 and 1997 coincided with a world-wide reduction in business tax and regulation. Reflecting this different era, the LLC is encumbered with none of the rules governing and limiting S corporations. An LLC can have multiple classes of ownership and there is no limitation on the number and type of owners.

When an entrepreneur sits down in my office to discuss starting a business, these differences play a leading role in our conversation. Why would someone subject themselves to S corporation restrictions and the possibility of inadvertent double taxation? Therefore, most choose to be an LLC.

This begs the question, why don't S corporations convert to LLCs? Converting from an S corporation to an LLC is a taxable event, making such a conversion prohibitively expensive. In essence, you would have to liquidate the business and pay taxes on any appreciated property. In my experience, no one is willing to go through that pain to gain LLC status.

That means existing S corporation businesses have three choices. They can pay a significant tax converting to an LLC, they can accept the competitive disadvantage under which they exist, or they can work with Congress to ease these limitations and bring their business structure closer to par with the LLC.

S Corporation Family Businesses

Another area of challenge for S corporations is during the transition of the business from one generation to the next. Although the number of S corporation shareholders is limited, the rules allow multiple members of a single family to be treated as just one of those shareholders. As S corporations enter their fourth and fifth generation, provisions like these allow the business to remain an S corporation.

On the other hand, the rule restricting the classes of stock makes it more difficult to retain multi-generational family members in the business. Under S corporation rules, you cannot issue preferred shares or other classes of stock that provide different levels of compensation to different shares. If you have a family-owned business with multiple shareholders, the ability to issue different classes of stock really helps keep family members involved in the future of the business.

Allowing S corporations to have multiple classes of stock would dramatically improve their ability to make the transition from one generation to the next.

Eliminating Obsolete Rules

In my experience, most new S corporations these days are former C corporations. The tax code includes a number of provisions designed to ensure that businesses converting from C to S corporation do not enjoy a tax windfall when they make that conversion. I believe in certain circumstances these provisions go too far.

For example, S corporations are subject to a corporate level tax on certain income and gains recognized within 10 years after they convert from C to S corporation. I find the built-in gains provision causes many S corporations to hold onto unproductive or old assets that should be replaced. Ten years is a long time. Many times I have experienced changes in the business environment or the economy during the 10 year period which prompt action that if taken would trigger this tax. This resulted in business owners not making the appropriate decision for the business and its stakeholders, because of the built-in gain tax.

In addition, an S corporation election is terminated when it is converted from a C corporation and has certain thresholds of passive investment income for three years. Also, the S corporation is subject to a special corporate level tax on such passive investment income.

Changing the built-in gains limitation to allow for assets to be reinvested in the business or reducing the built-in gains tax period from 10 to 7 years would assist in making appropriate business decisions, as circumstances change, and preserve the rule prohibiting tax windfalls from a sale of assets soon after converting to an S corporation. Also, modifying the passive investment income limitation, which generates a corporate level tax, and eliminating the passive income termination event, would eliminate unneeded limitations on S corporations.

Raising Capital

Raising capital is always a challenge for closely held businesses, even without the additional limitation faced by S corporations. Limiting the class of ownership and the types of owners adds another burden on the process.

When S corporations were created, Congress intended their owners to be real people, as opposed to holding companies, trusts, other corporations, etc. The idea was a simple corporate form for simple businesses. The world of business has changed in the past 50 years, and the limitations imposed on those simple businesses are now restricting the ability of established S corporations to access the capital they need.

Allowing S corporations to issue additional classes of stock and allowing non-resident aliens and IRAs as shareholders will enhance the ability of S corporations to access necessary capital.

Certainty of Tax Status

The S corporation is the only business structure where you can inadvertently lose your entity tax status. An S corporation election is terminated whenever the S corporation has excessive passive income, too many shareholders, an ineligible shareholder, or an arrangement that is considered a second class of stock. Often, these businesses are unaware they have violated the S corporation restrictions and it is discovered too late.

While Internal Revenue Code allows the IRS to absolve an S corporation and restate its S corporation status, it is entirely up to the Internal Revenue Service.

This also impacts the selling and purchasing of S corporations. In the last year, I was involved in three transactions relating to the sale or purchase of an S corporation where the remote possibility of the entity not satisfying the S corporation requirements during its entire existence stopped the transaction or resulted in a major modification of the terms of the transaction.

Changing the rules to allow an S corporation, without IRS consent, to rectify an ineffective election or a terminating event, increases tax status certainty to S corporations.

Conclusion

The S corporation has proven to be a huge success, but times have changed, and it is important for Congress to recognize that some of the rules governing S corporations need to change as well.

Legislation like Representative Shaw's bill (H.R. 4421), Representative Ramstad's bill (H.R. 2239), and others would greatly improve the rules governing S corporations and enable them to continue to compete with LLCs and other business structures on an even footing.

I appreciate the opportunity to address this subcommittee and I look forward to any questions you all might have.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

ORAL TESTIMONY (FOR THE RECORD) BEFORE

THE HOUSE SMALL BUSINESS SUBCOMMITTEE

ON REGULATORY REFORM AND OVERSIGHT

HEARING ON SUBCHAPTER S CORPORATIONS

JUNE 27, 2006

Chairman Akin, Ranking Member Bordallo and other distinguished members of this Subcommittee, the American Institute of Certified Public Accountants (AICPA) appreciates this opportunity to present testimony on the place of S corporations in our society and on the need to keep them vital and competitive by continuing to modernize the laws that govern Subchapter S of the Internal Revenue Code. We request that a written copy of this testimony be included in the official record of this hearing.

My name is Gregory Porcaro and I am the Chair of the AICPA S Corporation Technical Resource Panel. AICPA members assist S corporations of all sizes and in all industries nationwide, and their shareholders, with choice-of-entity decisions; organizational, transactional and acquisitive structuring; operational and distribution planning; return preparation; and many other services required daily by S corporation clients. It is from close involvement with these small, midsize and large clients, that we have developed insight into the impact of S corporations on our society and into needed changes that will enable S corporations to continue to be a primary vehicle for both start-ups and existing businesses to achieve operational growth, expanded employee ownership, and simplified and practical family succession planning. Personally, I am a majority shareholder and tax principal in a small, Rhode Island CPA firm with S corporation clients that range in size from $50,000 to $40 million in revenue. My firm annually prepares close to 600 S corporation tax returns.

S corporations are active in just about every sector of society: from health, educational and artistic service businesses; to construction, manufacturing and mining; to agricultural,

wholesale and retail establishments; the majority of corporate businesses that we deal with everyday and in every place are, in fact, S corporations. There are roughly three and a half million S corporations which together have invested in some $2.5 billion in assets, achieved $4.5 billion in gross receipts and employ millions of people. These engines of American entrepreneurship are not slowing down even with the fast growth of limited liability companies (LLCs) that still harbor certain advantages over today's S corporations.

Today, in our brief testimony I will cover some of the statutory changes that we believe should be made to Subchapter S. Collectively, these changes would eliminate needless traps, inequities, and complexities that, indeed, keep many corporations from electing to be an S corporation at all. Subchapter S can and should be modernized to expand its reach, to simplify transactions, to remove unintended consequences and to promote competition between corporate entities and LLCs.

Start-up business survivability is a critical area of concern. Census data indicates that 20 percent of start-up businesses disappear after one year, and 70 percent after 10 years. Small businesses that struggle with and file for bankruptcy over operational, financial, and tax problems could prevent many of their problems by having adequate year-around access to CPAs and other advisors. The AICPA, therefore, supports the *Small Business Tax Flexibility Act of 2005*, H.R. 4006, and its 2006 companion bill in the Senate, S. 2462, which would give most S corporation and partnership start-ups the flexibility to adopt any fiscal year-end from April through November. Such flexibility would:

- Spread a start-up business' regulatory, financial, and tax burdens away from their busiest operational periods, thus increasing productivity;
- Spread the regulatory, financial and tax workload of CPAs and other advisors throughout the year, thus promoting a more balanced family-work protocol for advisors;
- Increase the occurrence of non-extendable financial and regulatory deadlines, such as bank loan paperwork or HUD filings, outside of the tax "busy" season;
- Provide the same flexibility that C corporations (typically larger businesses) have in choosing the right fiscal year-end for the business;
- Provide certain start-ups with increased cash flow because both real and opportunity costs of compliance are reduced as such work is delayed to a less productive period of the business cycle.

Another area of concern is a recent discussion to change the way S corporation shareholders pay employment taxes. The Joint Committee on Taxation has suggested that S corporation shareholders switch from the current withholding tax regime to the estimated tax payment system. Without addressing the merits and concerns of the Joint Committee at this time, we strongly suggest that if any changes are made, that they not be made to the S corporation regime, but rather that the issue be studied carefully and with extensive public input in an effort to work towards bringing the partnership model closer to the S corporation model of utilizing the FICA and W-2 system of reporting. S corporation shareholders should not be brought into the less efficient system of self-

employment and estimated tax payments as the payroll withholding system substantially decreases the likelihood that a taxpayer will underpay its tax liability as comprehension and compliance of that system is much easier and less burdensome for individuals.

Next, I will mention a few suggestions we find to be of particular importance:

First, the requirement that the difference between Last-In-First-Out (LIFO) and First-In-First-Out (FIFO) inventory – otherwise known as the LIFO Recapture Amount - be taxed upon conversion should be eliminated. In a typical economy of rising prices, C corporations don't ever pay taxes on LIFO layers and S corporations should not have to do so either. In most cases, this tax is a windfall to the government and the most prohibitive cost of conversion for many existing corporations desiring to make the S election – it is a tax the government would never have received had the S election not been made.

Second, an Electing Small Business Trust ought to be able to deduct interest expense incurred when it borrows funds to purchase S corporation stock. This would enable a business interest deduction that is available to all other taxpayers.

Third, excess passive investment income rules should be of a less punitive nature given the fact that investment of working capital into the financial markets is commonplace and unpredictable as to results. Accordingly, the tax rate on excess passive investment income, currently at the maximum corporate rate, should be lowered to 15 percent to

mirror that of the lowered personal holding company rate; the passive income threshold should be raised from 25 percent to 60 percent; and the requirement to pay a corporate level tax on excess passive income should be penalty enough and should not trigger a termination of the S election.

Fourth, S corporation shareholders should receive the same benefit from making charitable contributions as do individuals, partners or C corporations. To this end, when an S corporation makes a charitable contribution, the shareholders should be permitted to increase their stock bases by their share of the full fair market value of the contribution, not only, as under current law, by the basis of the contributed property. I personally have S corporation clients who planned to give inventory and other items to charitable organizations in the wake of the many recent disasters, but who then decided to not give after learning of their inability to receive a fair market value deduction for their gifts. The AICPA believes that charitable giving incentives should be equitable across the entity spectrum.

Fifth, when an S corporation's Qualified Subchapter S Subsidiary (QSub) is partially sold, the tax result is often very different than that of an S corporation that sold the same percentage of a wholly-owned LLC. Whether 21 percent, 60 percent or 99 percent of a QSub is sold, the parent S corporation must still pay tax on the gain as if it sold 100 percent of the assets of the subsidiary. Yet if an S corporation parent sells the same percentage of its wholly owned LLC, it would recognize gain on only the percentage

sold. This is a trap for unsuspecting taxpayers which requires complex and expensive tax planning to avoid and should be simplified to allow a straightforward result.

Sixth, S corporation shareholders should be permitted to increase basis in shareholder debt with funds borrowed from a related entity as long as the S corporation is legally responsible to repay the shareholder and the shareholder is personally and legally responsible to repay the debt to the related entity. Under case law, it is rare that a shareholder will receive debt basis unless the shareholder directly lends funds to its S corporation or takes borrowed funds from an unrelated entity and loans them to its S corporation. S corporation shareholders should be able to increase debt basis with proceeds borrowed from a related entity as long as the shareholder has a personal and legal obligation to repay the funds to the ultimate lending source and the loan is not between related entities.

The AICPA has a number of other recommendations that we do not have time to mention today. We ask that a recent letter to Senators Hatch and Lincoln describing these recommendations in more detail be included in the record of this hearing. We are pleased to be able to present this testimony before you today and will be delighted to answer any questions you may have about the items we have mentioned or any other areas relating to S corporations.

Thank you, Mr. Chairman, and distinguished members of this Subcommittee.

April 3, 2006

The Honorable Orrin G. Hatch
Hart Senate Office Building, Room 104
Washington, DC 20510-4402

The Honorable Blanche L. Lincoln
Dirksen Senate Office Building, Room 355
Washington, DC 20510-0404

Dear Senators Hatch and Lincoln:

The American Institute of Certified Public Accountants (AICPA) greatly appreciates your continued leadership in keeping Members of Congress aware of the need to modernize subchapter S of the Internal Revenue Code and to assist smaller businesses that frequently use this form of organization in remaining competitive. AICPA members understand and serve the technical and operational aspects of the vast majority of America's S corporations and are, therefore, in a unique position to also understand the needs for legislative change to subchapter S. With that background, we present the following suggestions for you to consider including in the next Subchapter S Modernization Act.

While our list below is not intended to change our previous support for other provisions (for example, see our letter to Senator Hatch dated June 8, 2001 and our testimony given June 18, 2003 before the House Ways & Means Subcommittee on Select Revenue Measures), the following important provisions should be a part of the *S Corporation Modernization Act of 2006*. The first six of these provisions have been introduced in prior versions of this bill.

1) Deductibility of interest expense incurred by an electing small business trust that acquires S corporation stock
2) Allowing back-to-back loans from related entities to a shareholder to create debt basis
3) Treating qualifying director shares not as S corporation stock
4) Treating liquidating losses to shareholders as ordinary losses
5) Allowing charitable contribution and foreign tax credit carryforwards from former C corporation period to net the section 1374[1] built-in gains tax
6) Appropriate income recognition upon the sale of an interest in a qualified subchapter S subsidiary (QSub)

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[1] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 (IRC) or the regulations thereunder, both as amended through the date of this memorandum.

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7) Repealing the LIFO recapture tax under section 1363(d)
8) Expanding the section 1377 post-termination transition period to include the filing of an amended return
9) Lowering the tax rate on passive investment income to 15 percent

We have provided detailed explanations of our recommendations below.

1) *Deductibility of interest expense incurred by an electing small business trust that acquires S corporation stock* - The AICPA strongly supports enactment of this provision. Current reg. section 1.641(c)-1 provides that interest expense incurred by an ESBT to acquire stock in an S corporation is allocable to the S portion of the trust, but is not deductible by the ESBT because it is not an administrative expense of the trust. While the position taken in the regulations may be technically supportable, the AICPA believes this position is inconsistent with tax policy with respect to other business interest deductions and should be changed. Other taxpayers are entitled to deduct interest incurred to acquire an interest in a passthrough entity; to disallow an ESBT a deduction for such interest is patently unfair. There is no indication that Congress intended to place ESBTs at a disadvantage relative to other taxpayers. In fact, Congress created ESBTs to facilitate family succession planning. Allowing these family-oriented trusts to deduct the interest appropriately remedies this significant problem and greatly reduces the barriers to using them. A retroactive effective date for this provision would enable interest deductions on amended returns for ESBTs unaware of this trap at the time they structured purchases of such stock.

2) *Allowing back-to-back loans from related entities to a shareholder to create debt basis* - The AICPA strongly supports this provision which removes a significant trap for the unwary, especially shareholders of unsophisticated S corporations. Section 1366(d)(1) limits the amount of a shareholder's pro rata share of corporate losses that may be taken into account to the sum of (1) the basis in the stock, plus (2) the basis of any shareholder loans to the S corporation. The debt must run directly to the shareholder for the shareholder to receive basis for this purpose; the creditor may not be a person related to the shareholder. It is not uncommon for the shareholders of an S corporation to own related entities. Often times, loans are made among these related entities. Under current law, it is extremely difficult for the shareholders of an S corporation to restructure these loans in order to create basis in the S corporation against which losses of the S corporation may be claimed. The ability to create loan basis through the restructuring of related party loans has been the subject of numerous court cases and is an area of much uncertainty. This provision will protect these taxpayers from an unfair and unwarranted fate by providing that true indebtedness from an S corporation to a shareholder increases section 1366(d) basis, irrespective of the original source of the funds to the corporation.

3) *Treating qualifying director shares not as S corporation stock* - Currently, banks are mired in a web of competing regulations from various federal and state governmental

agencies that traditionally have not been written with subchapter S in mind. Banks that otherwise qualify for S corporation status are either forced to find a way to work around a literal interpretation of the second class of stock rules so that the director shares are not so treated, or they find themselves unable to make an S election because of arcane and non-tax related banking rules. This provision would bring long-awaited certainty with no revenue loss to the government.

4) *Treating liquidating losses to shareholders as ordinary losses* - In the case of a liquidation of an S corporation, current law can result in double taxation because of a mismatch of ordinary income (realized at the corporate level and passed through to the shareholder) and a capital loss (recognized at the shareholder level on the liquidating distribution). Although careful tax planning can avoid this result, many S corporations do not have the benefit of sophisticated tax advice. Enacting this provision would eliminate this potential trap by providing that any portion of any loss recognized by an S corporation shareholder on amounts received by the shareholder in a distribution in complete liquidation of the S corporation would be treated as an ordinary loss to the extent of the shareholder's basis in the S corporation stock.

5) *Allowing charitable contribution and foreign tax credit carryforwards from former C corporation period to net the section 1374 built-in gains tax* - Current law does not allow a shareholder to offset C corporation charitable contribution carryovers against S corporation built-in gains. This common-sense change provides that charitable contribution and other carryforwards arising from a taxable year for which the corporation was a C corporation shall be allowed as a deduction against the net recognized built-in gain (or, as applicable, as a credit against the built-in gains tax) of the corporation for the taxable year. There is no structural reason why these carryforwards should not offset built-in gains or the built-in gains tax.

6) *Appropriate income recognition upon the sale of an interest in a qualified subchapter S subsidiary (QSub)* - Under reg. section 1.1361-5(b)(3) Examples 1 and 9, which apply section 351 to a section 1361(b)(3)(c) QSub termination, an S corporation may be required to recognize 100 percent of the gain inherent in a QSub's assets if it sells anywhere between 21 and 100 percent of the QSub stock to an unrelated party. Section 351 requires the recognition of gain on the transfer of assets for stock if the transfer does not result in 80 percent or better corporate control. Where the S corporation sells 21 percent of the QSub stock, the S corporation will maintain only 79 percent control and will, therefore, be subject, under section 351, to gain recognition not only on the 21 percent sold, but also on the 79 percent deemed to be transferred back to the former QSub. In reality, the S corporation parent still owns 79 percent of the subsidiary and should not be required to pay tax on something it didn't sell. Many taxpayers that sell less than 100 percent are unpleasantly surprised by this trap for the unwary.

This result is counter to sound tax policy regarding the recognition of gains upon disposition because the S corporation, in effect, is required to recognize gain on assets without making any disposition of those assets. The QSub regulations include an example suggesting that this result can be avoided by merging the QSub into a single member LLC prior to the sale, then selling an interest in the LLC (as opposed to stock of the QSub). The law should be simplified to remove this trap and to eliminate needless restructuring to avoid an inappropriate tax result. Enacting this provision would cause an appropriate percentage of gain to be recognized while removing the complicated and needless restructuring requirement.

Given the generally higher level of sophistication of C corporation taxpayers, we imply no suggestion regarding eradication of this problem in the subchapter C context.

7) *Repealing the LIFO recapture tax under section 1363(d)* - Often times the most significant hurdle faced by a corporation desiring to elect S corporation status is the LIFO recapture tax under section 1363(d). In many cases, this tax makes it cost-prohibitive for a corporation to elect S status. The LIFO recapture tax was enacted in 1987 in response to concerns that a taxpayer using the LIFO method of accounting, upon conversion to S corporation status, could avoid a corporate-level tax on LIFO layers established while the corporation was a C corporation because under section 1374, the S corporation would only be subject to a corporate-level tax on LIFO layers for the first 10 years after conversion.

We believe these concerns are unfounded. The purpose of the built-in gains tax, as explained in its legislative history, is to prevent avoidance of tax on corporate-level gains through conversion to S status. A C corporation (or generally any other taxpayer) with LIFO layers does not recognize gain with respect to the layers unless and until they are invaded. In equal measure, a C corporation that elects S status should not have to recognize gain with respect to the LIFO layers unless and until the layers are invaded.

In our experience, most corporations, whether S or C, hold base LIFO layers far longer than the 10-year recognition period (often holding them indefinitely). There is no data to suggest that S corporations deplete such layers any faster than their C corporation counterparts (for example, in year 11 of the S election). While any concern over revenue loss is understandable, section 1363(d) just does not square with the reality of businesses that use LIFO inventory accounting. Absent the recapture tax rule of section 1363(d), many corporations that have not yet made an S election because of the recapture tax will now make such an election, but not because such a repeal would enable them to avoid a LIFO tax that they would otherwise pay as a C corporation. The reality is that C corporations do not often pay this tax.

The LIFO recapture tax on S corporations as it currently exists, therefore, is primarily a windfall to the government - a tax on S corporations that would normally not have been imposed on C corporations at all. It makes no sense to penalize corporations for making an election under Subchapter S simply because they have LIFO inventory. Section 1363(d) should be repealed to correct this unwarranted tax on electing S corporations and to remove this significant hurdle for corporations that qualify to and should otherwise be permitted to make the S election.

8) *Expanding the section 1377 post-termination transition period to include the filing of an amended return.* The PTTP of section 1377(b)(1) should be expanded to include the filing of an amended return for an S year. Accordingly, section 1377(b)(1)(B) should be amended to read as follows:

> (B) the 120-day period beginning on
>
> (i) the date that an amended return is filed, or
> (ii) the date of any determination pursuant to an audit of the taxpayer
>
> which follows the termination of the corporation's election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2), and

Because our proposal would appear in section 1377(b)(1)(B), section 1377(b)(3) (added by the *Working Families Tax Relief Act of 2004*) would apply to prevent abuses. The granting of the 120-day PTTP should be based on the recognition that legitimate changes to an original return can be made in several ways including through audit or through the filing of a taxpayer-initiated amended return.

We recognize that there is no statutory provision permitting the filing of an amended return; such a return is a "creature of administrative origin and grace." If it is not possible, therefore, to codify the above recommendation, the bill should require the Secretary of the Treasury to prescribe this result by regulation.

9) *Lowering the tax rate on passive investment income to 15 percent* - As several long-overdue changes are being proposed to the passive investment income rules, and as these changes would bring the punitive nature of this regime closer in form and substance to the personal holding company (PHC) rules, we recommend that the tax rate on passive investment income be lowered to 15 percent as was recently done for PHCs by Section 302(e) of the *Jobs and Growth Tax Relief Reconciliation Act of 2003*.

* * * * * * *

We appreciate the opportunity for input into the *Subchapter S Modernization Act of 2006*. Should you have any questions regarding any of our recommendations, please contact me at (402) 280-2062 or tpurcell@creighton.edu; Gregory Porcaro, Chair of the S Corporation Taxation Technical Resource Panel, at (401) 739-9250 or gporcaro@oppgcpa.com; or Marc A. Hyman, AICPA Technical Manager at (202) 434-9231 or mhyman@aicpa.org at any time.

Sincerely,

Thomas J. Purcell, III, Chair
Tax Executive Committee

CC: Mr. Evan Liddiard, Tax Policy Advisor to Sen. Hatch
Ms. Anna Taylor, Legislative Assistant to Sen. Lincoln

June 27, 2006

House Committee on Small Business
Subcommittee on Regulatory Reform and Oversight
"S Corporations -- Their History and Challenges"

Statement of Richard Roderick
Dead River Company, Bangor, Maine

Chairman Akin, Ranking Member Bordallo, and distinguished members of the Committee.

My name is Richard Roderick. I am Senior Vice President and CFO of the Dead River Company in Portland, Maine, a family-owned business approaching its 100th year. I also serve on the Board of Directors of the S Corporation Association.

I would like to thank the Committee for holding this important hearing, and I'm pleased to have the opportunity to testify on the state of S corporations in America.

History of the Dead River Company

From marketing lobsters, potatoes, and medical supplies to the production of lumber and wood products, Dead River Company has been involved in a variety of business ventures during its history. The company was founded in 1907 by Charles Hutchins. The company has its roots in the forest products industry and was named for the river that flowed through much of its timberland in Western Maine.

In the 1930's, Curtis Hutchins took over management of the company from his father and began to diversify into new lines of business. In 1936, he acquired a heating oil company and a small chain of gasoline stations. This acquisition marked the entrance of Dead River Company into the petroleum business.

In 1981, nearly all of the company's remaining forest lands were sold to the Passamaquoddy Tribe and the Penobscot Indian Nation as part of an historic settlement of claims over title to public and private lands in Maine. The land sale provided the opportunity for Dead River Company to enter the commercial real estate business.

Today the company's primary focus is the distribution of petroleum products in Maine, New Hampshire, and Vermont and commercial real estate development and management.

As a member of senior management at the Dead River Company, I have been privileged to serve as a financial steward for three generations of the ownership family. I have been focused on keeping our corporate cost of capital competitive, and S corporation status has proven absolutely critical in accomplishing that goal.

In electing S corporation status in 1988, the company had to make some sacrifices. We had to forego our LIFO election with respect to petroleum products; we agreed to hold

appreciated assets for at least ten years or otherwise pay a punitive built-in gains tax; we had to dispose of a Canadian subsidiary; we had to collapse several classes of stock; and we had to go to court to modify trust structures.

But the ultimate benefit was significant. It's allowed us to thrive as a regional distributor of energy products and to grow a successful real estate division – neither of which would have been possible under the taxation rules of a C corporation. That said, our S corporation status imposes ongoing limitations on our business operations as well. Absent these limitations, I believe the Dead River Company and other S corporations could be even more successful at creating jobs and anchoring communities.

History of the S Corporation

Before Congress created S corporations, entrepreneurs had two basic choices when starting a business. They could form a regular C corporation, enjoy liability protection, but face two layers of federal tax at the corporate and individual level. Or they could form a partnership, enjoy a single layer of taxation at the individual level, but sacrifice the umbrella of liability protection.

Neither choice was optimal. In 1946, the Department of Treasury suggested a third option – merging a single layer of federal tax with comprehensive liability protection. President Dwight Eisenhower joined the cause, and promoted the passage of legislation to encourage small business growth and entrepreneurship.

In 1958, Congress acted on President Eisenhower's recommendation, creating subchapter S of the tax code. In exchange for enjoying a single layer of tax, entrepreneurs electing S corporation status agreed to certain limitations. They had to be a domestic corporation with resident shareholders. Shareholders had to be individuals (no trusts or corporate shareholders), and the structure of the business had to be simple with just one class of stock.

How significant was the creation of subchapter S? Consider that in 1958, the top income tax rate was 52 percent for corporations and 91 percent for individuals. That means dividends paid by a C corporation to a high-income shareholder faced an effective tax rate of 96 percent! Even a shareholder with median family income faced an effective federal tax of more than 60 percent. Creation of the S corporation was a huge step forward in eliminating a devastating double tax and encouraging small and family business creation in the United States.

Nearly a half century later, S corporations are the most popular corporate structure in America. The IRS estimates that there were 3.2 million S corporations in the United States in 2002 – compared to approximately 2.1 million C corporations and 2.3 million LLCs and other partnerships.

But while the S corporation community grew and evolved, the rules governing S corporations remained largely the same. Moreover, while S corporations are the most common form of corporate or partnership structure, the advent of the Limited Liability

Corporation has given entrepreneurs a new, popular option when forming their businesses.

The combination of rapid growth and the development of new, competing business forms presents two distinct challenges for S corporations. First, Congress needs to modernize the S corporation structure to keep them viable and relevant. Second, the S corporation community needs to defend against efforts to unfairly raise taxes on small and family-owned businesses.

Modernizing the S Corporation Structure

The S corporation community's ongoing challenge to stay competitive has numerous friends on the Hill. Legislation introduced by Rep. Clay Shaw (R-FL), H.R. 4421, would dramatically improve the rules governing S corporations. The bill, entitled "The S Corporation Reform Act of 2005" would:

- Increase access to capital by reducing S corporation ownership restrictions;
- Reduce double taxation of American business by easing transition rules for C corporations that convert to S corporation status;
- Increase S corporation flexibility by allowing multiple classes of stock and convertible debt; and
- Protect S corporations from crippling taxes in the event they inadvertently violate their S corporation status.

Consider a multi-generation family business like the Dead River Company. Today we face several large challenges. With successful enterprises operating in two distinct markets, energy distribution and commercial real estate, we would like to reorganize along business lines – but passive income rules present a very significant obstacle.

Stock transfers to the successor generations are critical if the company is to avoid an unplanned and onerous redemption to fund estate taxes – but such transfers are expensive (gift taxes are involved) and present their own uncertainty in terms of valuation and timing.

If the company were to seek additional equity capital, the pool of potential investors is dramatically reduced by the S corporation eligibility requirements.

Legislation introduced by Congressman Clay Shaw of Florida, H.R. 4421, the S Corporation Reform Act, would help with several of these unique challenges, and better position S corporations to compete against other businesses structured as LLCs.

Defeating Unfair Tax Increases

Improving the S corporation structure is one challenge facing today's S corporation. Fighting to preserve the principle of one layer of taxation is another.

As an example, in their 2005 "Options to Improve Tax Compliance and Reform Tax Expenditures" report, the Joint Committee on Taxation proposed a $57 billion tax increase (over 10 years) by applying federal payroll taxes against all S corporation net income, regardless of whether it derives from labor or capital investment. For small S corporations, this proposal represents a 15 percentage point tax increase, while for larger S corporations, the tax increase would amount to nearly 3 percentage points.

The Treasury Inspector General for Tax Administration (TIGTA) has also weighed in, arguing that all net income from S corporations that are more than 50 percent owned by a single shareholder should be subject to payroll taxes. TIGTA testified before the Senate Finance Committee that "...the S corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses." TIGTA estimates that more than three-quarters (79 percent) of S corporations would see their taxes increase under this proposal.

Congress created S corporations to encourage family business creation by eliminating the double layer of tax on closely-held corporations. Congress' intent was reflected in the IRS Revenue Ruling establishing that S corporations should pay payroll taxes on salaries paid to shareholders only, not S corporation profits. Today, the IRS enforces this ruling by applying a "reasonable compensation" standard to S corporation owners who actively participate in their business. Applying payroll taxes to all S corporation income, including income derived from capital investment, is simply a backdoor means of reinstating double taxation – exactly the opposite of what Congress intended.

The Dead River Company invests millions of dollars in new buildings, equipment, and training every year to make sure we provide the best service, reliability, and value to our customers. Applying payroll taxes to the income derived from this investment is simply wrong. Further, in Dead River's instance there is no question of whether the income should be attributed to labor – no family members are presently on the payroll.

The S Corporation Association is working closely with other business groups, members of Congress, and the Administration to ensure that S corporations are not unfairly targeted for tax increases.

Mr. Chairman, once again I would like to thank you for holding this hearing and allowing me to testify. I appreciate your interest in S corporations and am prepared to answer any questions you might have.

ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

Statement for the Record
House Committee on Small Business Subcommittee on Regulatory Reform and Oversight
Hearing on S Corporations—Their History and Challenges
June 27, 2006

As the Small Business Committee examines the history and challenges of S corporations, the Employee-Owned S Corporations of America ("ESCA"), on behalf of member companies and their employee-owners, appreciates the opportunity to share our unique concerns and views on several important issues.

ESCA is the leading voice of the employee-owned S corporation community, serving to protect and promote employee ownership of private Subchapter S businesses for workers across the nation. ESCA was formed in 1999, and in its short history represents more than 45,000 employee-owners. Member companies operate in virtually every state in the nation, engaging in a broad spectrum of business activities that range from heavy manufacturing to hospitality. All sizes of companies are represented (from large firms with 7,000 employee-owners to small operations with as few as 50 employee-owners). ESCA companies are a hallmark of American entrepreneurship, providing jobs and a key retirement savings opportunity for tens of thousands of American workers.

Employee-owned S corporations have been in existence since 1998. They are pass-through entities owned in part or fully by an employee stock ownership plan ("ESOP"). As such, these entities offer their employees a "piece of the rock" as a retirement savings opportunity. In this sense, S corporation ESOPs are much more than standard retirement savings plans; hundreds of thousands of employees who own a stake in their employers through ESOPs are amassing impressive nest eggs – often hundreds of thousands of dollars or more – that enable them to retire from line jobs with dignity and free from the need for federal support.

ESCA is submitting this statement to the Small Business Committee to call attention to several policy concerns of ESCA members. The first are issues in the pension reform bill now being negotiated by a House-Senate conference committee. Another concern is the treatment of S corporations in the 2005 report of the President's Advisory Panel on Federal Tax Reform.

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I. Pension Reform Legislation

ESCA and its members are lobbying tax and pension lawmakers on two issues of critical importance to employee-owned S corporations in pension reform legislation (H.R. 2830).

A. Anti-Abuse Rules

The first issue of interest to ESCA members in the pension reform legislation is making permanent the 2001 anti-abuse rules for employee-owned S corporations. These rules, which are found under section 409(p) of the Internal Revenue Code, ensure that such companies are formed and operate to the benefit of all employees. Unless extended, the section 409(p) provision and the other pension, 401(k) and retirement savings incentives enacted in 2001 will expire in the year 2010.

The House included in its pension reform bill a permanent extension of these anti-abuse rules (as well as the permanent extension of all the retirement savings provision of the 2001 tax bill). The Senate did not include these permanency provisions in its version of pension reform because the $12.4 billion revenue cost would have made the bill harder to pass. ESCA wants these anti-abuse rules made permanent to ensure that employee-owned S corporations continue to provide safe and secure retirement savings for all rank-and-file employees.

B. Vesting of Employer Contributions

The second issue of concern in the pension reform debate to ESCA members is a Senate provision that would change current law to require faster vesting of employer contributions to defined contribution plans, including S corporation ESOPs. The Senate provision would change the current vesting schedule from a 5-year cliff and 7-year graded vesting schedule to a 3-year cliff and 6-year graded vesting schedule. ESCA has told Congress that the proposed change in vesting schedules would increase the share repurchase liabilities of S corporations, which threatens their ability to meet loan repayment schedules and comply with financial covenants required by their lenders. A "partial fix" for these concerns is included in the bill as a result of ESCA's recent advocacy efforts on this issue. It would delay the faster vesting rules for each S corporation until the ESOP's exempt loans (loans incurred to purchase S corporation stock and outstanding as of September 26, 2005) are fully repaid or the date on which the loans were scheduled to be repaid as of September 26, 2005.

Although ESCA was able to gain some measure of relief in the Senate bill, ESCA continues to work for a solution that eliminates all of the potential adverse effects this vesting change could have on ESCA members.

II. President's Advisory Panel on Federal Tax Reform

While S corporations are a tremendous benefit to employee-owners of these companies, they are also uniquely structured entities that are vulnerable to changes in the tax code and in pension laws. Indeed, the unique structure of employee-owned S corporations raises questions about how they might be treated under the new retirement security paradigm recommended by the President's Advisory Panel on Federal Tax Reform (the "Panel"). Given this, ESCA and its members are concerned, first, with the Panel's proposal to apply an entity-level tax on S corporations and all other non-C corporations (except sole proprietorships). Without an

exemption for employee-owned S corporations similar to the exemption the Panel envisions for regulated investment companies ("RICs") and real estate investment trusts ("REITs"), an entity-level tax on an ESOP's share of S corporation income would eliminate the ability of the company's employee-owners to build up meaningful retirement savings.

Another concern of ESCA's members is that the Panel's employer-based "Save at Work" proposal does not address ESOPs. The omission of ESOPs in the Panel's proposal to streamline several current defined contribution plans into one "Save at Work" retirement plan suggests that ESOPs might be affected by this sweeping change. While we do not believe that the Panel intended to eliminate ESOPs, we do believe that any tax reform proposal put forward by the Congress should confirm the important function that S corporation ESOPs in particular have in helping the employee-owners of these companies amass substantial retirement income through their ownership stake in these companies.

A. Entity-Level Tax

Under the Panel's Simplified Income Tax Plan ("SITP"), all large businesses – those with more than $10.5 million in receipts – would be taxed at the entity level, paying a 31.5 percent rate. The Panel's report recognizes the importance of making certain exceptions to this rule, and exempts RICs and REITs from the entity-level tax. Under the Panel's Growth and Investment Tax Plan ("GITP"), businesses other than sole proprietorships would pay a corporate rate of 30 percent at the entity level, although it is unclear whether a tax-exempt shareholder's share of business income would be taxed.

If Congress does ultimately support an entity-level tax system similar to the SITP or GITP, it is critical that employee-owned S corporations be allowed to retain their current pass-through attributes and not be subjected to the entity-level tax with respect to the ESOP's share of S corporation income. Congress quite specifically designed the S corporation ESOP structure to ensure only one level of taxation, and adding another tax at the entity level would clearly go against Congress' intent, while undermining the retirement savings attributes of the S corporation ESOP to employee-owners of these companies.

The pass-through structure is especially important for employee-owned S corporations because it allows these companies to rapidly grow retirement wealth in the ESOP for their employees. An entity-level tax would, for many employee-owned companies, reduce by nearly one-third the amount of funds available for retirement savings in the ESOP.

Moreover, a tax paid at the entity-level by these companies is equivalent in substance to the qualified retirement plan (the ESOP as the owner) paying income taxes. This result runs counter to long-standing tax policy, whereby participants (employee shareholders in the case of employee-owned S corporations) in qualified plans are not taxed until income is received upon retirement.

B. Clarity Needed for ESOPs

A second concern raised by the Panel is that it did not address the role of ESOPs in the context of its proposed new tax treatment of defined contribution plans. The Panel's SITP and GITP call for the consolidation of the following employer-sponsored defined contribution plans into the "Save at Work" plan: 401(k), 'SIMPLE 401(k),' Thrift, 403(b), governmental 457(b), 'SARSEP,' and SIMPLE IRA. ESOPs are left out of the analysis. Although ESOPs are not explicitly singled out for consolidation in the Panel's report, some in the business community

have expressed fears that the Panel envisions that all defined contribution plans, including ESOPs, should be consolidated into its "Save at Work" plan.

ESOPs are, as this Committee is aware, a key economic asset to thousands of companies and their employees. Employee-owned S corporations are an increasingly utilized business structure found across the nation and in every state, and with their proliferation has come an important increase in the retirement savings of the ESOP participants in these companies. Fuelled by the work and commitment of their employee-owners, these companies provide jobs for workers across the economic and industrial spectrum, including manufacturing, construction, health care, trucking and tourism. Indeed, a recent study by the National Center for Employee Ownership that surveyed nearly 2,000 employee-owners from S corporation ESOP companies around that nation found that:

- Have account balances three to five times higher than the U.S. average for 401(k) plans – with large numbers of these ESOP participants amassing $75,000 to $100,000 in their accounts;
- Have even higher account balances – five to seven times the average for 401(k) plans – when measured among employee-owners nearing retirement age; and
- Quit at a rate of half the national average, and are fired or laid off two-thirds less frequently than workers in other kinds of companies.

ESCA believes that Members of Congress recognized the tremendous promise of S corporation ESOPs when legislators first created these structures, and we note that employee-owned S corporations have long enjoyed broad bipartisan support on Capitol Hill. Indeed just five years ago, Congress reaffirmed its support for employee-owned S corporations during consideration of the Economic Growth and Tax Relief Reconciliation Act (P.L. 107-16). In 2001, the Ways and Means Committee said that it "continues to believe that S corporations should be able to encourage employee ownership through an ESOP."[1]

With this in mind, and given the pervasiveness of ESOPs and the major role they play in providing a secure source of retirement income for retirees, we respectfully urge members of the Small Business Committee to ensure that any tax reform proposal put forward by Congress recognize and affirm the continued existence of ESOPs, and S corporation ESOPs more specifically.

* * *

ESCA appreciates the Small Business Committee's consideration of the concerns and interests of S corporations. We would welcome the opportunity to discuss these issues further with Committee members and staff in the weeks and months ahead.

[1] H.R. Rep. No. 107-51, part 1, at 100 (2001).

ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

ESCA MEMBER COMPANIES 2006

Member Company	*Headquarters Location*
Acadian Ambulance	Louisiana
Agron, Inc.	California
Albert C. Kobayashi	Hawaii
Alion Science and Technology	Virginia
Amerequip, Inc.	Wisconsin
Amsted Industries	Illinois
Antioch Company	Ohio
Appleton	Wisconsin
Appleton Marine	Wisconsin
Austin Industries, Inc.	Texas
BCC Capital Partners	California
Bimba Manufacturing	Illinois
Columbia Financial Advisors	Oregon
Community Bancshares, Inc.	Missouri
Crowe Chizek & Co.	Ohio
Deloitte	Illinois
The Dexter Company	Iowa
DuCharme, McMillen & Associates	Illinois
Duff & Phelps, LLC	Illinois
ESOP Services	Virginia
First Bankers Trust Services	Illinois
Ferrell Companies, Inc.	Kansas
Floturn, Inc.	Ohio
Freeman Companies	Texas
Garney Companies, Inc.	Missouri
The George P. Johnson Company	Michigan
GreatBanc Trust	Illinois
Greenheck Fan Corporation	Virginia
Herff-Jones, Inc.	Indiana
Hisco	Texas
Holborn Corporation	New York
Houlihan, Lokey, Howard and Zukin	Illinois
Inland Truck Parts Company	Kansas
Katten Muchin Rosenman LLP	Illinois
Keller Structures	Wisconsin
Krieg DeVault Alexander	Indiana
Lake Welding Supply Company, Inc.	Michigan

LaSalle Bank, N.A.	Illinois
Lifetouch, Inc.	Minnesota
McDermott, Will and Emery	Illinois
Messer Construction Company	Ohio
Molin Concrete Products	Minnesota
Moretrench American Corporation	New Jersey
Morgan Lewis and Bockius	Illinois
Muehlstein & Co., Inc.	Connecticut
Nathan Alterman Electric Co., Inc.	Texas
The Parksite Group	Illinois
Pavement Recycling Systems, Inc.	California
PERCS USA Inc.	Florida
Performance Contracting Group, Inc	Kansas
Phelps County Bank	Missouri
Pridgeon & Clay, Inc.	Michigan
The Principal Financial Group	Wisconsin
Richard Goettle, Inc.	Ohio
Round Table Pizza, Inc.	California
RSM McGladrey	Iowa
Schreiber Foods, Inc.	Wisconsin
Scitor Corporation	California
Scot Forge Company	Illinois
Segerdahl Corporation	Illinois
Social & Scientific Systems	Maryland
Sonalysts, Inc.	Connecticut
Spee Dee Delivery Service, Inc.	Minnesota
State Street Bank	Massachusetts
Stout Risius Ross, Inc.	Illinois
The Scooter Store	Texas
Sundt	Arizona
Thirdpage Services	Virginia
Thoits Insurance	California
Thybar Construction	Illinois
Vector Health Sytems, Inc.	Rhode Island
Vermeer Equipment of Texas Inc	Texas
Volkert & Associates	Alabama
Walman Optical Company	Minnesota
Williams Brothers Construction	Texas
Woodfold Inc.	Oregon

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