S CORPORATION
MODERNIZATION ACT OF 2017
Summary of Provisions

Section 1 – Short Title

The bill is referred to as the "S Corporation Modernization Act of 2017."

Section 2 – Expansion of Qualifying Beneficiaries of an Electing Small Business Trust

Shareholders of an S corporation generally must be real people living in the United States, with limited exceptions certain trusts, estates and tax-exempt organizations. As result, non-resident aliens may not be shareholders of S corporations. This prohibition dates back to the origins of Subchapter S, and it distinguishes S corporations from the rules that apply to partnerships and limited liability companies, which may have foreign ownership.

Under current law, an electing small business trust (ESBT) may be a shareholder of an S corporation, but the same limitations that apply to S-corporation shareholders also apply to ESBT beneficiaries – including the prohibition against non-resident aliens.

This provision would allow a nonresident alien to be an eligible beneficiary of an ESBT holding S-corporation stock, and thus, nonresident aliens would be permitted, through the ESBT, to be shareholders of the S corporation.

- The provision would help ensure that more family-owned businesses stay in the family while opening doors for S corporations to raise capital and expand their operations outside the United States.

- The provision also would eliminate the unintended consequence of terminating an existing S-corporation election when a nonresident alien becomes a beneficiary of an ESBT holding S-corporation stock.

- The ESBT rules ensure that U.S. taxes are paid on the S corporation's income. When a trust shareholder elects to be treated as an ESBT, it taxed on its share of the S corporation's income at the highest applicable U.S. tax rate, before any earnings are distributed to the beneficiaries. As a result, the residency of the trust beneficiaries of an ESBT is of no tax consequence.

- In the 110th Congress, this provision was reported out of the Senate Finance Committee and passed in the Senate as part of a larger package.

Section 3 – Modifications to Passive Income Rules

The excess passive investment tax applies to S corporations that have undistributed C corporation earnings and profits. These rules – sometimes called the "sting tax" – apply to an S corporation that was previously a C corporation or acquired a C corporation with undistributed earnings and profits.

The passive investment tax is a corporate-level tax that applies to S corporations with a significant amount of passive income (i.e., royalties, rents, dividends, interest and annuities). It applies if more than 25 percent of the S corporation's gross receipts are derived from passive investment income. The tax is assessed at the maximum corporate rate (35 percent) and, like the built-in gains tax, is applied on top of any other applicable taxes. Similar rules apply to C corporations treated as personal holding companies; however, the passive-income threshold is 60 percent of the C corporation's gross receipts.

In addition to the passive investment tax, if an S corporation's passive income exceeds the 25-percent threshold for three consecutive years, it may lose its status as an S corporation.

The provision would (1) raise the Sting Tax passive-income threshold to 60 percent of gross receipts, and (2) repeal the "three years and out" restriction on an S corporation's status.

- These changes were recommended by the Joint Committee on Taxation in its 2001 tax simplification report and were included in the Camp Tax Reform Act of 2014 (H.R. 1, 113th Congress).

- For small S corporations that often cannot afford cutting-edge tax planning, the Sting Tax can be an unwelcome surprise, with too many S corporations forced to pay the tax because they inadvertently exceeded the passive-income threshold.

- The tax forces S corporations to use capital inefficiently – money is diverted away from business reinvestment, capital expansion projects, and job creation to pay expensive tax planning, or tax and penalties, for little or no public purpose.

- The "three years and out" rule also is a trap for the unwary. S corporations that lose their tax status under this rule revert to C corporation status, which comes with back taxes and penalties and often comes too late for the business to correct the problem and save the S corporation.

Section 4 -- S Corporation IRA Shareholders

Banks were first allowed to organize as S corporations following enactment of the Small Business and Job Protection Act of 1996. Because S corporations are not allowed to be owned within an individual retirement account (IRA), some banks were unable to make the new election because they had IRA shareholders. In addition, severe "prohibited transaction" penalties made it unworkable for the IRA owner or the bank to buy the stock out of the IRAs.

Congress addressed this situation in 2004 with the American Jobs Creation Act (AJCA), which allowed banks with stock held by an IRA on October 22, 2004 to make S-corporation elections. Like other qualified retirement plans (e.g., 401(k) plans), AJCA required the IRA to pay "unrelated business income tax" (UBIT), which is computed at corporate tax rates, on its share of S-corporation income each year. The IRA also is required to pay UBIT on any gain realized when it sells any of the stock of the S corporation.

The provision would allow IRAs to hold the stock of any S corporation, whether it is engaged in banking or not. Consistent with the current law treatment for qualified retirement plans, the IRA would be subject to UBIT on its share of the S corporation's income and on any gain from the disposition of S-corporation shares.

- As Congress considers options for improving access to capital for businesses, this policy not only would resolve the disparate treatment between S-corporation shares held by a qualified retirement plan and an IRA, but it also would open up another avenue for small businesses, which often have limited access to the public markets, to access needed capital to expand their businesses and create jobs.

- It also addresses a flaw in AJCA, which treated S-corporation shares held by an IRA on the date of enactment differently than an IRA holding the same shares a day later. In addition, while current law precludes IRAs from qualifying as a shareholder in a non-bank S corporation, a qualified retirement plan, such as a 401(k) plan, is a permissible shareholder. Such disparate treatment also creates a trap for the unwary: If an employee owns shares in the S corporation through a qualified retirement plan, such as a 401(k) plan, and subsequently rolls the account including those shares into an IRA, the S corporation's election could be at risk. This provision would eliminate this pitfall and provide equal treatment of IRAs owning S-corporation shares.

Section 5 – Charitable Contributions for ESBTs

Before the enactment of the Small Business and Job Protection Act of 1996, S-corporation shareholders were limited in their ability to engage in basic estate tax planning because the only trusts eligible to hold S-corporation stock – grantor trusts and qualified subchapter S trusts (QSST) – were prohibited from having multiple beneficiaries or from accumulating earnings.

To address these limitations, the 1996 Act created electing small business trusts (ESBT) as eligible S-corporation shareholders. In contrast to grantor trusts and QSSTs, an ESBT can have multiple beneficiaries and is not required to distribute its income currently. These differences allow an individual to establish a trust to hold S-corporation stock and spread the trust's income over time and to multiple family members or other beneficiaries of the trust.

ESBTs have their limitations, however. For example, current law does not allow them to claim a deduction for certain charitable contributions made by the S corporation, even though an individual who owns shares directly in the S corporation would be eligible for that deduction.

The provision would conform the rule applicable to ESBTs to the rule applicable to individual shareholders of an S corporation and allow an ESBT to claim a deduction for its share of charitable contributions made by the S corporation.

- The provision would treat S-corporation shareholders equally whether they own the shares directly or through an ESBT.

- It also would eliminate an impediment for S corporations that chose to make charitable contributions and thus would encourage charitable giving.

Section 6 – Basis Step-up for S Corporation Assets

In general, upon the death of a partner or an S-corporation shareholder, the basis of the decedent's partnership interest or S-corporation stock is adjusted to the fair market value as of the date of death. While this adjustment applies to the basis of the partnership interest or S-corporation stock (commonly referred to as the "outside basis"), it does not apply to the basis of the business' assets (the "inside basis"). In many cases, this adjustment results in a "step up" or increase in the outside basis. Partnerships also may elect to adjust the inside basis of the business' assets. There is no similar election for an S corporation to adjust the inside basis of its assets.

The provision would provide greater parity for S corporations by allowing an election to adjust the inside basis of the S corporation's depreciable or amortizable assets upon the death of an S-corporation shareholder. The step-up in basis would be amortizable over a 15-year period and allow the individual inheriting the S-corporation shares to claim as a deduction 1/15th of the stepped-up basis each year. Other shareholders would not be affected. No amortization deduction would be allowed after the termination of the S corporation or after the sale of S-corporation stock by the individual inheriting the stock.

- Individuals who inherit appreciated shares in an S corporation upon the death of a shareholder are treated differently from individuals who inherit interests in a partnership because there is no election available to adjust the inside basis of the S corporation's assets.

- Under certain circumstances, an S corporation may be able to address the lack of basis step-up upon the death of a shareholder by liquidating the S corporation. Such a transaction, however, is an extreme solution and unfair to other shareholders who would be taxed on the appreciation in the value of their shares if the S corporation were liquidated.

Section 7 – Streamlined Procedures for S Corporation Elections

To qualify as an S corporation, a corporation must make an election on IRS Form 2553 for the first year it wishes to be treated as an S corporation and do so no later than the 15th day of the third month after the close of that year. For example, a corporation that qualifies to be an S corporation in 2016 must make its election by March 15, 2017. A timely made election is effective for that tax year if the corporation meets all eligibility requirements for the period prior to filing the election and all the required shareholders consent to the election. If these requirements are not met, the election becomes effective for the following tax year. An election continues in effect for subsequent tax years until it is terminated (including revocation by the taxpayer).

Similar rules apply to an election to treat an S-corporation subsidiary as a qualified S-corporation subsidiary (QSub) – which allows the S corporation to treat the subsidiary as a division of the S corporation and file a single return. In addition, qualified subchapter S trusts (QSST) and electing small business trusts (ESBT) may elect to qualify as S-corporation shareholders if the election is made by the 15th day of the third month after the transfer of stock to the trust.

The provision would simplify the election process by permitting a corporation to elect on its income tax return to be treated as an S corporation for the tax year to which the return relates, provided that the return is filed by the applicable due date (with extensions). In addition, the provision would

apply election procedures to QSubs that are similar to the rules for electing S-corporation status and permit the IRS to coordinate the election rules for a QSST and ESBT with the new election rules for S corporations and QSubs. The provision also would provide that the IRS may accept as timely a late filed revocation if there is reasonable cause shown.

- For its first tax year, an S corporation can fail to file its initial S-corporation election on time (e.g., March 15th), especially if the business has requested an extension to file its first return as an S corporation. Such a failure to file the election will cause the corporation to retain its C corporation status, even though it has filed an S-corporation tax return for the year. The provision simplifies the process and eliminates potential election errors by allowing the initial S-corporation election to be made on the first S-corporation return.

- The provision also allows the IRS to coordinate the election process and filing dates for QSubs, QSSTs and ESBTs to help eliminate potential errors and improve efficiency.

- For S corporations seeking to revoke their election, the failure to meet the filing deadline can result in the corporation erroneously filing a C corporation return even though it has retained its S-corporation status. The provision would allow the IRS to accept late-filed revocations if the corporation can show reasonable cause for the error.