S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

May25, 2016

Dear Chairmen and Ranking Members:

The Department of Treasury's proposed regulations under section 385 threaten to disrupt normal operations of businesses throughout the economy, including businesses with no overseas operations and no opportunity to shift income from one tax jurisdiction to another. They threaten businesses organized as S corporations in particular, including their continued ability to remain as S corporations.

At publication, these proposed regulations were described as a response to the base erosion practices of certain companies, but this description fails to capture the true breadth of their impact. Our understanding is that Prop. Treas. Reg. §1.385-1 is intended to apply to any loan between members within a "modified expanded group," as defined in the rule, which can include not only corporations, but partnerships and individuals as well. That's it. No inversion or base erosion activity is required. As such, it would apply to a broad array of common business practices conducted in the purely domestic context.

And while this rule applies to all types of corporations, it poses a particular threat to S corporations. Unlike a C corporation, an S corporation is not allowed to have more than one class of stock. Otherwise, it can lose its S election. As drafted, the proposed section 385 regulations have the potential to disqualify a large percentage of S corporations by recharacterizing regular business loans as equity, thereby creating a second class of stock, as well as potentially violating the shareholder eligibility rules under subchapter S.

For example, it is common for entrepreneurs to organize their operations into so-called "brother-sister" companies to house the various assets and operations of the business. An entrepreneur might create one S corporation to house the operating business and another to hold the real estate. This structure helps to facilitate financing and liability protection, and there are few, if any, tax advantages for this arrangement. It is set up to achieve other perfectly legitimate business objectives.

So consider a domestic manufacturing business organized as two "brother-sister" companies. If one company lends the other money for any purpose – for working capital, to finance an investment, to pay taxes, under a cash pooling arrangement -- that loan could be recharacterized as part debt and part equity under the proposed rule.

This recharacterization would violate the single class of stock rule for the S corporation receiving the loan, thereby invalidating the company's S corporation election. As a result, the company must either seek relief from the IRS – which could take years and tens of thousands of dollars in IRS filing fees, as well as legal and other professional fees -- or be subject to substantial additional taxes on some or all of its income going back for all years still open under the statute of limitations. Such a result is obviously burdensome and expensive and could, depending on the extent of the tax consequences, threaten the very existence of the business.

The "brother-sister" company relationship described above is extremely common and, with variations, is in place for tens of thousands, if not hundreds of thousands, of businesses operating in the United States. It is now made drastically more burdensome, and potentially catastrophic, under the proposed regulations.

The existing tax Code recognizes the danger to S corporations of having their debt recharacterized as equity. The regulations under section 1361 of the Code were carefully crafted to ensure that related party debt does not unnecessarily and gratuitously endanger S corporation status in situations where the underlying purpose of the loan is not to circumvent the tax rules. There is even a statutory safe harbor for so-called "straight debt" that clearly should not be overridden as an unintended consequence of the proposed rule.

Loss of an S corporation election is just one example of how the proposed regulations could hurt businesses throughout the United States. Given this broad, negative effect, we request that Congress join us in calling on Treasury to withdraw the rules and work with interested stakeholders to ensure that future section 385 regulations do not gratuitously and unnecessarily disrupt normal business practices. At the very least, Congress should ask Treasury to amend any rules imposed in the near future to restrict their application to the international areas of concern identified by Treasury when the proposed regulations were initially published.

We appreciate your consideration of this very serious matter.

Sincerely,

Brian Reardon
President – S Corporation Association