S CORPORATION MODERNIZATION ACT OF 2016
Summary of Provisions

Section 1 -- Short Title

"S Corporation Modernization Act of 2016"

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

With few exceptions, shareholders of S corporations are limited to real people living in the United States. As such, non-resident aliens are disqualified from becoming 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. Those entities are allowed 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 allows a nonresident alien to be an eligible beneficiary of an ESBT holding S corporation stock.

- The provision is a significant step towards eliminating the unnecessary limitation against S corporations having foreign shareholders. It would help ensure that more family-owned businesses stay in the family while opening doors for S corporations to raise capital, expand abroad or partner with businesses operating outside the United States.

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

- ESBT rules ensure that all taxes are paid. When a trust shareholder elects to be treated as an ESBT, it agrees to pay the tax on all of its S corporation earnings at the trust level and at the highest applicable tax rate, before any earnings are distributed to the shareholder. The residency of the trust beneficiaries of an ESBT is of no tax consequence since the trust is paying tax rather than the beneficiaries.

(Related Legislation: 114th Congress – H.R. 2788; 113th Congress – H.R 892; 112th Congress- H.R. 1478 Section 5; 111th Congress- H.R. 2910 Section 5, S. 996 Section 5; H.R. 4840 Section 3; 110th Congress- H.R. 1591 Sec. 526 of the Senate-passed version of the Small Business Tax Package, S. 3063 Section 5)

Section 3 -- Modifications to Passive Income Rules

The excess passive investment tax applies to S corporations that have undistributed C corporation earnings and profits. An S corporation could be in this position because it converted from C status or because it acquired a C corporation with undistributed earnings.
Also referred to as the "Sting Tax," the passive investment tax is a corporate-level penalty levied against S corporations on their passive income (e.g. rents, royalties, interest and annuities) that

exceeds 25 percent of the S corporation's gross receipts. 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. By comparison, C corporations have a 60 percent passive income threshold.

Under the passive investment tax, an S corporation may lose its status if it has excess passive income for three consecutive years.

The provision would 1) raise the Sting Tax threshold to 60 percent of gross receipts and 2) eliminate the "three years and out" restriction..

- These changes were recommended by the Joint Committee on Taxation in their 2001 tax simplification report and included in the Camp Tax Reform Act of 2014.

- Given its draconian nature, oftentimes S corporations that pay the sting tax do so because they are too small or unsophisticated to understand the rules before they inadvertently violate them.

- This is an inefficient use of S corporation revenues – money is being diverted away from business reinvestment, capital expansion and job expansion to pay expensive tax planning, or IRS penalties, for little or no public purpose.

- S corporations are the only business entities that can lose their tax status, resulting in a reversion to C corporation status together with the application of back taxes and penalties. These actions would come on top of the "sting taxes" that would apply to an S corporation with excess passive income.

(Related Legislation: 114th Congress – H.R. 2788; 113th Congress – H.R. 892; 112th Congress- H.R. 1478 Section 3; 111th Congress- H.R. 2910 Section 4, S. 996 Section 4; 110th Congress- H.R. 4840 Section 5, S. 3063 Section 4; 109th Congress- H.R. 4297 Sec. 302 of Senate-passed version of Budget Reconciliation)

Section 4 -- S Corporation IRA Shareholders

Banks were initially allowed to organize as S corporations following enactment of the Small Business and Job Protection Act of 1996. Some banks, however, were unable to make the election because they had IRA shareholders. S corporations are not allowed to have IRA shareholders, and severe "prohibited transaction" penalties made it unworkable for the IRA owner or the bank to buy the stock out of the IRAs.

Congress acted in 2004 to address this issue of IRA shareholders of banks. The American Jobs Creation Act (AJCA) allowed banks with stock held by an IRA on October 22, 2004 to make S corporation elections. The AJCA required the IRA to pay "unrelated business income tax" (UBIT) on their share of S corporation income, as well as a second round of UBIT on "any gain on the disposition of stock in the S corporation." UBIT is computed at corporate rates.

The provision would allow IRAs to hold stock in all S corporations, consistent with current law treatment for qualified retirement plans. The pass-through income is UBIT to the IRA shareholder.

- As Congress considers options for improving access to capital for businesses, this policy would not only resolve the disparate treatment between qualified plan and IRA shareholders, but would also open up another avenue for private businesses (with limited access to the public markets) to access needed capital.

- It also addresses a flaw in the original 2004 law. If an employee owns shares in the S corporation through an IRA and subsequently rolls those shares into another qualified plan, the S corporation's S election could be at risk. Preserving the election would require substantial filing and professional fees and months or years in IRS negotiations and uncertainty for all of the shareholders of the S corporation. This provision would eliminate this pitfall.

(Related Legislation: 114th Congress – H.R. 2788; 113th Congress – H.R. 892;112th Congress- H.R. 1478 Section 6; 111th Congress- H.R. 2910 Section 6, S. 996 Section 6; 110th Congress- H.R. 4840 Section 6, S. 3063 Section 6)

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 at the time – Grantor Trusts and qualified subchapter S trusts – were prohibited from having multiple beneficiaries or for accumulating earnings.

To address these limitations, the 1996 Act created electing small business trusts (ESBTs) as eligible S corporation shareholders. In contrast with QSST and Grantor Trusts, 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 to multiple family members (or others) who are beneficiaries of the trust.

ESBT's have their limitations, however. For example, current law does not allow electing small business trusts to claim a deduction for certain charitable contributions attributed to an S corporation, even though individual shareholders of the S corporation outside the trust are eligible for that deduction.

The provision would conform the rule applicable to electing small business trusts to the rule applicable to individual shareholders of an S corporation.

- The provision would encourage charitable giving by S corporations and would eliminate a significant difference in the tax treatment of an S corporation's individual and non-individual shareholders.

(Related Legislation: 112th Congress- H.R. 1478 Section 7; 111th Congress- H.R. 2910 Section 7, S. 996 Section 7; 110th Congress- H.R. 4840 Section 7, S. 3063 Section 7, and Sen. Cardin amendment offered to Senate Small Business Package H.R. 1591)

Section 6 – Basis Parity for S Corporation Assets

Under section 1014, generally 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 at the date of death. This adjustment applies to the basis of the partnership interest or S corporation stock, commonly referred to as "outside basis", but not to the basis of the business's assets. In many cases, this adjustment would be a step-up or increase in outside basis. Under section 754, partnerships may elect to also adjust the basis of the underlying business' assets, commonly known as "inside basis", as well. There is no similar election to adjust the inside basis available to S corporation shareholders.

The provision would provide greater parity for S corporations by allowing an election to adjust the inside basis of the S corporation's assets upon the death of an S corporation shareholder. The step-up in basis would be amortizable over a 15 year period. The annual amortization deduction would only apply with respect to the transferee shareholder and would not impact other shareholders. No amortization deduction would be allowed after the termination of the S corporation or after the sale of S corporation stock by the transferee.

- Taxpayers receiving appreciated shares in an S corporation upon the death of a shareholder are disadvantaged compared to taxpayers receiving interests in a partnership because there is no election available to adjust the inside basis of the S corporation's assets.

- While, under certain circumstances, an S corporation can address the lack of basis step-up upon the death of a shareholder by liquidating the S corporation, such a transaction is unfair to other shareholders who did not inherit their stock as it would cause them to recognize a taxable gain.