

## SMALL BUSINESS JOB PROTECTION ACT OF 1996

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AUGUST 1, 1996.—Ordered to be printed  
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Mr. ARCHER, from the committee of conference,  
submitted the following

### CONFERENCE REPORT

[To accompany H.R. 3448]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 3448), to provide tax relief for small businesses, to protect jobs, to create opportunities, to increase the take home pay of workers, to amend the Portal-to-Portal Act of 1947 relating to the payment of wages to employees who use employer owned vehicles, and to amend the Fair Labor Standards Act of 1938 to increase the minimum wage rate and to prevent job loss by providing flexibility to employers in complying with minimum wage and overtime requirements under that Act, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

#### TITLE I

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment, insert the following:

(b) *TABLE OF CONTENTS.*—

*Sec. 1. Short title; table of contents.*

#### *TITLE I—SMALL BUSINESS AND OTHER TAX PROVISIONS*

*Sec. 1101. Amendment of 1986 Code.*

*Sec. 1102. Underpayments of estimated tax.*

#### *Subtitle A—Expensing; Etc.*

*Sec. 1111. Increase in expense treatment for small businesses.*

*Sec. 1112. Treatment of employee tips.*

*Sec. 1113. Treatment of storage of product samples.*

*Sec. 1114. Treatment of certain charitable risk pools.\*COM003\**

- Sec. 1115. Treatment of dues paid to agricultural or horticultural organizations.*
- Sec. 1116. Clarification of employment tax status of certain fishermen.*
- Sec. 1117. Modifications of tax-exempt bond rules for first-time farmers.*
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- Sec. 1302. Electing small business trusts.*
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- Sec. 1305. Rules relating to inadvertent terminations and invalid elections.*
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## **TITLE I—SMALL BUSINESS AND OTHER TAX PROVISIONS**

**SEC. 1101. AMENDMENT OF 1986 CODE.**

*Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or*

repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

**SEC. 1102. UNDERPAYMENTS OF ESTIMATED TAX.**

No addition to the tax shall be made under section 6654 or 6655 of the Internal Revenue Code of 1986 (relating to failure to pay estimated tax) with respect to any underpayment of an installment required to be paid before the date of the enactment of this Act to the extent such underpayment was created or increased by any provision of this title.

## **Subtitle A—Expensing; Etc.**

**SEC. 1111. INCREASE IN EXPENSE TREATMENT FOR SMALL BUSINESSES.**

(a) **GENERAL RULE.**—Paragraph (1) of section 179(b) (relating to dollar limitation) is amended to read as follows:

“(1) **DOLLAR LIMITATION.**—The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed the following applicable amount:

<b>“If the taxable year begins in:</b>	<b>The applicable amount is:</b>
1997 .....	18,000
1998 .....	18,500
1999 .....	19,000
2000 .....	20,000
2001 or 2002 .....	24,000
2003 or thereafter .....	25,000.”.

(b) **EFFECTIVE DATE.**—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1996.

**SEC. 1112. TREATMENT OF EMPLOYEE TIPS.**

(a) **EMPLOYEE CASH TIPS.**—

(1) **REPORTING REQUIREMENT NOT CONSIDERED.**—Subparagraph (A) of section 45B(b)(1) (relating to excess employer social security tax) is amended by inserting “(without regard to whether such tips are reported under section 6053)” after “section 3121(q)”.

(2) **TAXES PAID.**—Subsection (d) of section 13443 of the Revenue Reconciliation Act of 1993 is amended by inserting “, with respect to services performed before, on, or after such date” after “1993”.

(3) **EFFECTIVE DATE.**—The amendments made by this subsection shall take effect as if included in the amendments made by, and the provisions of, section 13443 of the Revenue Reconciliation Act of 1993.

(b) **TIPS FOR EMPLOYEES DELIVERING FOOD OR BEVERAGES.**—

(1) **IN GENERAL.**—Paragraph (2) of section 45B(b) is amended to read as follows:

“(2) **ONLY TIPS RECEIVED FOR FOOD OR BEVERAGES TAKEN INTO ACCOUNT.**—In applying paragraph (1), there shall be taken into account only tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary.”.

**SEC. 1207. EXTENSION OF BINDING CONTRACT DATE FOR BIOMASS AND COAL FACILITIES.**

(a) *IN GENERAL.*—Subparagraph (A) of section 29(g)(1) (relating to extension of certain facilities) is amended by striking “January 1, 1997” and inserting “July 1, 1998” and by striking “January 1, 1996” and inserting “January 1, 1997”.

(b) *EFFECTIVE DATE.*—The amendment made by this section shall take effect on the date of the enactment of this Act.

**SEC. 1208. MORATORIUM FOR EXCISE TAX ON DIESEL FUEL SOLD FOR USE OR USED IN DIESEL-POWERED MOTORBOATS.**

Subparagraph (D) of section 4041(a)(1) (relating to the imposition of tax on diesel fuel and special motor fuels) is amended by redesignating clauses (i) and (ii) as clauses (ii) and (iii), respectively, and by inserting before clause (ii) (as redesignated) the following new clause:

“(i) no tax shall be imposed by subsection (a) or (d)(1) during the period beginning on the date which is 7 days after the date of the enactment of the Small Business Job Protection Act of 1996 and ending on December 31, 1997.”.

## **Subtitle C—Provisions Relating to S Corporations**

**SEC. 1301. S CORPORATIONS PERMITTED TO HAVE 75 SHAREHOLDERS.**

Subparagraph (A) of section 1361(b)(1) (defining small business corporation) is amended by striking “35 shareholders” and inserting “75 shareholders”.

**SEC. 1302. ELECTING SMALL BUSINESS TRUSTS.**

(a) *GENERAL RULE.*—Subparagraph (A) of section 1361(c)(2) (relating to certain trusts permitted as shareholders) is amended by inserting after clause (iv) the following new clause:

“(v) An electing small business trust.”.

(b) *CURRENT BENEFICIARIES TREATED AS SHAREHOLDERS.*—Subparagraph (B) of section 1361(c)(2) is amended by adding at the end the following new clause:

“(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period.”.

(c) *ELECTING SMALL BUSINESS TRUST DEFINED.*—Section 1361 (defining S corporation) is amended by adding at the end the following new subsection:

“(e) *ELECTING SMALL BUSINESS TRUST DEFINED.*—

“(1) *ELECTING SMALL BUSINESS TRUST.*—For purposes of this section—

“(A) *IN GENERAL.*—Except as provided in subparagraph (B), the term ‘electing small business trust’ means any trust if—

“(i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, or

(III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c) which holds a contingent interest and is not a potential current beneficiary,

“(i) no interest in such trust was acquired by purchase, and

“(ii) an election under this subsection applies to such trust.

“(B) CERTAIN TRUSTS NOT ELIGIBLE.—The term ‘electing small business trust’ shall not include—

“(i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust, and

“(ii) any trust exempt from tax under this subtitle.

“(C) PURCHASE.—For purposes of subparagraph (A), the term ‘purchase’ means any acquisition if the basis of the property acquired is determined under section 1012.

“(2) POTENTIAL CURRENT BENEFICIARY.—For purposes of this section, the term ‘potential current beneficiary’ means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. If a trust disposes of all of the stock which it holds in an S corporation, then, with respect to such corporation, the term ‘potential current beneficiary’ does not include any person who first met the requirements of the preceding sentence during the 60-day period ending on the date of such disposition.

“(3) ELECTION.—An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

“(4) CROSS REFERENCE.—

“**For special treatment of electing small business trusts, see section 641(d).**”.

(d) TAXATION OF ELECTING SMALL BUSINESS TRUSTS.—Section 641 (relating to imposition of tax on trusts) is amended by adding at the end the following new subsection:

“(d) SPECIAL RULES FOR TAXATION OF ELECTING SMALL BUSINESS TRUSTS.—

“(1) IN GENERAL.—For purposes of this chapter—

“(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

“(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

“(2) MODIFICATIONS.—For purposes of paragraph (1), the modifications of this paragraph are the following:

“(A) Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e).

“(B) The exemption amount under section 55(d) shall be zero.

“(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

“(i) The items required to be taken into account under section 1366.

“(ii) Any gain or loss from the disposition of stock in an S corporation.

“(iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii). No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

“(D) No amount shall be allowed under paragraph (1) or (2) of section 1211(b).

“(3) TREATMENT OF REMAINDER OF TRUST AND DISTRIBUTIONS.—For purposes of determining—

“(A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and

“(B) the distributable net income of the entire trust, the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

“(4) TREATMENT OF UNUSED DEDUCTIONS WHERE TERMINATION OF SEPARATE TRUST.—If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642(h) shall be taken into account by the entire trust.

“(5) ELECTING SMALL BUSINESS TRUST.—For purposes of this subsection, the term ‘electing small business trust’ has the meaning given such term by section 1361(e)(1).”.

(e) TECHNICAL AMENDMENT.—Paragraph (1) of section 1366(a) is amended by inserting “, or of a trust or estate which terminates,” after “who dies”.

**SEC. 1303. EXPANSION OF POST-DEATH QUALIFICATION FOR CERTAIN TRUSTS.**

Subparagraph (A) of section 1361(c)(2) (relating to certain trusts permitted as shareholders) is amended—

(1) by striking “60-day period” each place it appears in clauses (ii) and (iii) and inserting “2-year period”, and

(2) by striking the last sentence in clause (ii).

**SEC. 1304. FINANCIAL INSTITUTIONS PERMITTED TO HOLD SAFE HARBOR DEBT.**

Clause (iii) of section 1361(c)(5)(B) (defining straight debt) is amended by striking “or a trust described in paragraph (2)” and inserting “a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money”.

**SEC. 1305. RULES RELATING TO INADVERTENT TERMINATIONS AND INVALID ELECTIONS.**

(a) GENERAL RULE.—Subsection (f) of section 1362 (relating to inadvertent terminations) is amended to read as follows:

“(f) INADVERTENT INVALID ELECTIONS OR TERMINATIONS.—If—

“(1) an election under subsection (a) by any corporation—  
 “(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

“(B) was terminated under paragraph (2) or (3) of subsection (d),

“(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

“(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

“(A) so that the corporation is a small business corporation, or

“(B) to acquire the required shareholder consents, and

“(4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,

then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.”.

(b) *LATE ELECTIONS, ETC.*—Subsection (b) of section 1362 is amended by adding at the end the following new paragraph:

“(5) *AUTHORITY TO TREAT LATE ELECTIONS, ETC., AS TIMELY.*—If—

“(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year or no such election is made for any taxable year, and

“(B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year (and paragraph (3) shall not apply).”.

(c) *EFFECTIVE DATE.*—The amendments made by subsection (a) and (b) shall apply with respect to elections for taxable years beginning after December 31, 1982.

**SEC. 1306. AGREEMENT TO TERMINATE YEAR.**

Paragraph (2) of section 1377(a) (relating to pro rata share) is amended to read as follows:

“(2) *ELECTION TO TERMINATE YEAR.*—

“(A) *IN GENERAL.*—Under regulations prescribed by the Secretary, if any shareholder terminates the shareholder’s interest in the corporation during the taxable year and all affected shareholders and the corporation agree to the application of this paragraph, paragraph (1) shall be applied to the affected shareholders as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

“(B) *AFFECTED SHAREHOLDERS.*—For purposes of subparagraph (A), the term ‘affected shareholders’ means the

shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If such shareholder has transferred shares to the corporation, the term ‘affected shareholders’ shall include all persons who are shareholders during the taxable year.”

**SEC. 1307. EXPANSION OF POST-TERMINATION TRANSITION PERIOD.**

(a) *IN GENERAL.*—Paragraph (1) of section 1377(b) (relating to post-termination transition period) is amended by striking “and” at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C), and by inserting after subparagraph (A) the following new subparagraph:

“(B) the 120-day period beginning on 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”.

(b) *DETERMINATION DEFINED.*—Paragraph (2) of section 1377(b) is amended by striking subparagraphs (A) and (B), by redesignating subparagraph (C) as subparagraph (B), and by inserting before subparagraph (B) (as so redesignated) the following new subparagraph:

“(A) a determination as defined in section 1313(a), or”.

(c) *REPEAL OF SPECIAL AUDIT PROVISIONS FOR SUBCHAPTER S ITEMS.*—

(1) *GENERAL RULE.*—Subchapter D of chapter 63 (relating to tax treatment of subchapter S items) is hereby repealed.

(2) *CONSISTENT TREATMENT REQUIRED.*—Section 6037 (relating to return of S corporation) is amended by adding at the end the following new subsection:

“(c) *SHAREHOLDER’S RETURN MUST BE CONSISTENT WITH CORPORATE RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.*—

“(1) *IN GENERAL.*—A shareholder of an S corporation shall, on such shareholder’s return, treat a subchapter S item in a manner which is consistent with the treatment of such item on the corporate return.

“(2) *NOTIFICATION OF INCONSISTENT TREATMENT.*—

“(A) *IN GENERAL.*—In the case of any subchapter S item, if—

“(i) the corporation has filed a return but the shareholder’s treatment on his return is (or may be) inconsistent with the treatment of the item on the corporate return, or

“(ii) the corporation has not filed a return, and

“(iii) the shareholder files with the Secretary a statement identifying the inconsistency, paragraph (1) shall not apply to such item.

“(B) *SHAREHOLDER RECEIVING INCORRECT INFORMATION.*—A shareholder shall be treated as having complied with clause (ii) of subparagraph (A) with respect to a subchapter S item if the shareholder—

“(i) demonstrates to the satisfaction of the Secretary that the treatment of the subchapter S item on the shareholder’s return is consistent with the treat-

ment of the item on the schedule furnished to the shareholder by the corporation, and

“(ii) elects to have this paragraph apply with respect to that item.

“(3) **EFFECT OF FAILURE TO NOTIFY.**—In any case—

“(A) described in subparagraph (A)(i)(I) of paragraph (2), and

“(B) in which the shareholder does not comply with subparagraph (A)(ii) of paragraph (2), any adjustment required to make the treatment of the items by such shareholder consistent with the treatment of the items on the corporate return shall be treated as arising out of mathematical or clerical errors and assessed according to section 6213(b)(1). Paragraph (2) of section 6213(b) shall not apply to any assessment referred to in the preceding sentence.

“(4) **SUBCHAPTER S ITEM.**—For purposes of this subsection, the term ‘subchapter S item’ means any item of an S corporation to the extent that regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the corporation level than at the shareholder level.

“(5) **ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION.**—

“**For addition to tax in the case of a shareholder’s negligence in connection with, or disregard of, the requirements of this section, see part II of subchapter A of chapter 68.**”.

(3) **CONFORMING AMENDMENTS.**—

(A) Section 1366 is amended by striking subsection (g).

(B) Subsection (b) of section 6233 is amended to read as follows:

“(b) **SIMILAR RULES IN CERTAIN CASES.**—If a partnership return is filed for any taxable year but it is determined that there is no entity for such taxable year, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply.”.

(C) The table of subchapters for chapter 63 is amended by striking the item relating to subchapter D.

**SEC. 1308. S CORPORATIONS PERMITTED TO HOLD SUBSIDIARIES.**

(a) **IN GENERAL.**—Paragraph (2) of section 1361(b) (defining ineligible corporation) is amended by striking subparagraph (A) and by redesignating subparagraphs (B), (C), (D), and (E) as subparagraphs (A), (B), (C), and (D), respectively.

(b) **TREATMENT OF CERTAIN WHOLLY OWNED S CORPORATION SUBSIDIARIES.**—Section 1361(b) (defining small business corporation) is amended by adding at the end the following new paragraph:

“(3) **TREATMENT OF CERTAIN WHOLLY OWNED SUBSIDIARIES.**—

“(A) **IN GENERAL.**—For purposes of this title—

“(i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and

“(ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidi-

ary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

“(B) **QUALIFIED SUBCHAPTER S SUBSIDIARY.**—For purposes of this paragraph, the term ‘qualified subchapter S subsidiary’ means any domestic corporation which is not an ineligible corporation (as defined in paragraph (2)), if—

“(i) 100 percent of the stock of such corporation is held by the S corporation, and

“(ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

“(C) **TREATMENT OF TERMINATIONS OF QUALIFIED SUBCHAPTER S SUBSIDIARY STATUS.**—For purposes of this title, if any corporation which was a qualified subchapter S subsidiary ceases to meet the requirements of subparagraph (B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

“(D) **ELECTION AFTER TERMINATION.**—If a corporation’s status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make—

“(i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or

“(ii) an election under section 1362(a) to be treated as an S corporation,

before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.”

(c) **CERTAIN DIVIDENDS NOT TREATED AS PASSIVE INVESTMENT INCOME.**—Paragraph (3) of section 1362(d) is amended by adding at the end the following new subparagraph:

“(F) **TREATMENT OF CERTAIN DIVIDENDS.**—If an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term ‘passive investment income’ shall not include dividends from such C corporation to the extent such dividends are attributable to the earnings and profits of such C corporation derived from the active conduct of a trade or business.”

(d) **CONFORMING AMENDMENTS.**—

(1) Subsection (c) of section 1361 is amended by striking paragraph (6).

(2) Subsection (b) of section 1504 (defining includible corporation) is amended by adding at the end the following new paragraph:

“(8) An S corporation.”

**SEC. 1309. TREATMENT OF DISTRIBUTIONS DURING LOSS YEARS.**

(a) **ADJUSTMENTS FOR DISTRIBUTIONS TAKEN INTO ACCOUNT BEFORE LOSSES.**—

(1) Subparagraph (A) of section 1366(d)(1) (relating to losses and deductions cannot exceed shareholder’s basis in stock and debt) is amended by striking “paragraph (1)” and inserting “paragraphs (1) and (2)(A)”.

(2) Subsection (d) of section 1368 (relating to certain adjustments taken into account) is amended by adding at the end the following new sentence:

*“In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.”*

(b) ACCUMULATED ADJUSTMENTS ACCOUNT.—Paragraph (1) of section 1368(e) (relating to accumulated adjustments account) is amended by adding at the end the following new subparagraph:

*“(C) NET LOSS FOR YEAR DISREGARDED.—*

*“(i) IN GENERAL.—In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.*

*“(ii) NET NEGATIVE ADJUSTMENT.—For purposes of clause (i), the term ‘net negative adjustment’ means, with respect to any taxable year, the excess (if any) of—*

*“(I) the reductions in the account for the taxable year (other than for distributions), over*

*“(II) the increases in such account for such taxable year.”*

(c) CONFORMING AMENDMENTS.—Subparagraph (A) of section 1368(e)(1) is amended—

(1) by striking “as provided in subparagraph (B)” and inserting “as otherwise provided in this paragraph”, and

(2) by striking “section 1367(b)(2)(A)” and inserting “section 1367(a)(2)”.

**SEC. 1310. TREATMENT OF S CORPORATIONS UNDER SUBCHAPTER C.**

Subsection (a) of section 1371 (relating to application of subchapter C rules) is amended to read as follows:

*“(a) APPLICATION OF SUBCHAPTER C RULES.—Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.”*

**SEC. 1311. ELIMINATION OF CERTAIN EARNINGS AND PROFITS.**

(a) IN GENERAL.—If—

(1) a corporation was an electing small business corporation under subchapter S of chapter 1 of the Internal Revenue Code of 1986 for any taxable year beginning before January 1, 1983, and

(2) such corporation is an S corporation under subchapter S of chapter 1 of such Code for its first taxable year beginning after December 31, 1996,

the amount of such corporation’s accumulated earnings and profits (as of the beginning of such first taxable year) shall be reduced by an amount equal to the portion (if any) of such accumulated earnings and profits which were accumulated in any taxable year beginning before January 1, 1983, for which such corporation was an electing small business corporation under such subchapter S.

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (3) of section 1362(d), as amended by section 1308, is amended—

(A) by striking “SUBCHAPTER C” in the paragraph heading and inserting “ACCUMULATED”,

(B) by striking “subchapter C” in subparagraph (A)(i)(I) and inserting “accumulated”, and

(C) by striking subparagraph (B) and redesignating the following subparagraphs accordingly.

(2)(A) Subsection (a) of section 1375 is amended by striking “subchapter C” in paragraph (1) and inserting “accumulated”.

(B) Paragraph (3) of section 1375(b) is amended to read as follows:

“(3) PASSIVE INVESTMENT INCOME, ETC.—The terms ‘passive investment income’ and ‘gross receipts’ have the same respective meanings as when used in paragraph (3) of section 1362(d).”.

(C) The section heading for section 1375 is amended by striking “SUBCHAPTER C” and inserting “ACCUMULATED”.

(D) The table of sections for part III of subchapter S of chapter 1 is amended by striking “subchapter C” in the item relating to section 1375 and inserting “accumulated”.

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

**SEC. 1312. CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS UNDER AT-RISK RULES ALLOWED.**

Paragraph (3) of section 1366(d) (relating to carryover of disallowed losses and deductions to post-termination transition period) is amended by adding at the end the following new subparagraph:

“(D) AT-RISK LIMITATIONS.—To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder’s amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).”.

**SEC. 1313. ADJUSTMENTS TO BASIS OF INHERITED S STOCK TO REFLECT CERTAIN ITEMS OF INCOME.**

(a) IN GENERAL.—Subsection (b) of section 1367 (relating to adjustments to basis of stock of shareholders, etc.) is amended by adding at the end the following new paragraph:

“(4) ADJUSTMENTS IN CASE OF INHERITED STOCK.—

“(A) IN GENERAL.—If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

“(B) ADJUSTMENTS TO BASIS.—The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.”.

(b) *EFFECTIVE DATE.*—The amendment made by subsection (a) shall apply in the case of decedents dying after the date of the enactment of this Act.

**SEC. 1314. S CORPORATIONS ELIGIBLE FOR RULES APPLICABLE TO REAL PROPERTY SUBDIVIDED FOR SALE BY NONCORPORATE TAXPAYERS.**

(a) *IN GENERAL.*—Subsection (a) of section 1237 (relating to real property subdivided for sale) is amended by striking “other than a corporation” in the material preceding paragraph (1) and inserting “other than a C corporation”.

(b) *CONFORMING AMENDMENT.*—Subparagraph (A) of section 1237(a)(2) is amended by inserting “an S corporation which included the taxpayer as a shareholder,” after “controlled by the taxpayer.”.

**SEC. 1315. FINANCIAL INSTITUTIONS.**

Subparagraph (A) of section 1361(b)(2) (defining ineligible corporation), as redesignated by section 1308(a), is amended to read as follows:

“(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585.”.

**SEC. 1316. CERTAIN EXEMPT ORGANIZATIONS ALLOWED TO BE SHAREHOLDERS.**

(a) *ELIGIBILITY TO BE SHAREHOLDERS.*—

(1) *IN GENERAL.*—Subparagraph (B) of section 1361(b)(1) (defining small business corporation) is amended to read as follows:

“(B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(7)) who is not an individual.”.

(2) *ELIGIBLE EXEMPT ORGANIZATIONS.*—Section 1361(c) (relating to special rules for applying subsection (b)) is amended by adding at the end the following new paragraph:

“(7) *CERTAIN EXEMPT ORGANIZATIONS PERMITTED AS SHAREHOLDERS.*—For purposes of subsection (b)(1)(B), an organization which is—

“(A) described in section 401(a) or 501(c)(3), and

“(B) exempt from taxation under section 501(a),

may be a shareholder in an S corporation.”.

(b) *CONTRIBUTIONS OF S CORPORATION STOCK.*—Section 170(e)(1) (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end the following new sentence: “For purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer.”.

(c) *TREATMENT OF INCOME.*—Section 512 (relating to unrelated business taxable income), as amended by section 1113, is amended by adding at the end the following new subsection:

“(e) *SPECIAL RULES APPLICABLE TO S CORPORATIONS.*—

*“(1) IN GENERAL.—If an organization described in section 1361(c)(7) holds stock in an S corporation—*

*“(A) such interest shall be treated as an interest in an unrelated trade or business; and*

*“(B) notwithstanding any other provision of this part—*

*“(i) all items of income, loss, or deduction taken into account under section 1366(a), and*

*“(ii) any gain or loss on the disposition of the stock in the S corporation*

*shall be taken into account in computing the unrelated business taxable income of such organization.*

*“(2) BASIS REDUCTION.—Except as provided in regulations, for purposes of paragraph (1), the basis of any stock acquired by purchase (within the meaning of section 1012) shall be reduced by the amount of any dividends received by the organization with respect to the stock.”.*

*(d) CERTAIN BENEFITS NOT APPLICABLE TO S CORPORATIONS.—*

*(1) CONTRIBUTION TO ESOPS.—Paragraph (9) of section 404(a) (relating to certain contributions to employee ownership plans) is amended by inserting at the end the following new subparagraph:*

*“(C) S CORPORATIONS.—This paragraph shall not apply to an S corporation.”.*

*(2) DIVIDENDS ON EMPLOYER SECURITIES.—Paragraph (1) of section 404(k) (relating to deduction for dividends on certain employer securities) is amended by striking “a corporation” and inserting “a C corporation”.*

*(3) EXCHANGE TREATMENT.—Subparagraph (A) of section 1042(c)(1) (defining qualified securities) is amended by striking “domestic corporation” and inserting “domestic C corporation”.*

*(e) CONFORMING AMENDMENT.—Clause (i) of section 1361(e)(1)(A), as added by section 1302, is amended by striking “which holds a contingent interest and is not a potential current beneficiary”.*

*(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.*

**SEC. 1317. EFFECTIVE DATE.**

*(a) IN GENERAL.—Except as otherwise provided in this subtitle, the amendments made by this subtitle shall apply to taxable years beginning after December 31, 1996.*

*(b) TREATMENT OF CERTAIN ELECTIONS UNDER PRIOR LAW.—For purposes of section 1362(g) of the Internal Revenue Code of 1986 (relating to election after termination), any termination under section 1362(d) of such Code in a taxable year beginning before January 1, 1997, shall not be taken into account.*

*House bill*

No provision.

*Senate amendment*

The Senate amendment provides a two-year extension of the ten-year grandfather rule for existing partnerships. Thus, under the Senate amendment, the present-law provision treating publicly traded partnerships as corporations applies to existing partnerships for taxable years beginning after December 31, 1999.

*Effective date.*—The provision takes effect as if included in the 1987 Act.

*Conference agreement*

The conference agreement does not include the Senate amendment provision.

## C. PROVISIONS RELATING TO S CORPORATIONS

## 1. S CORPORATIONS PERMITTED TO HAVE 75 SHAREHOLDERS

(Sec. 1301 of the House bill and the Senate amendment.)

*Present law*

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

*House bill*

The House bill increases maximum number of eligible shareholders from 35 to 75.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 2. ELECTING SMALL BUSINESS TRUSTS

(Sec. 1302 of the House bill and the Senate amendment.)

*Present law*

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S

trusts” may not be shareholders in an S corporation. A “qualified subchapter S trust” is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary’s income interest must terminate at the earlier of the beneficiary’s death or the termination of the trust, and (4) if the trust terminates during the beneficiary’s life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

*House bill*

*In general*

The House bill allows stock in an S corporation to be held by certain trusts (“electing small business trusts”). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, “purchase” means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. A trust must elect to be treated as an electing small business trust.

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

*Treatment of items relating to S corporation stock*

The portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust’s income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trust’s income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income is not included in the distributable net income of the trust, and thus is not included in

the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) is taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

*Treatment of remainder of items held by trust*

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income does not include any income attributable to the S corporation stock.

*Termination of trust and conforming amendment applicable to all trusts*

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The bill makes a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

3. EXPANSION OF POST-DEATH QUALIFICATION FOR CERTAIN TRUSTS

(Sec. 1303 of the House bill and the Senate amendment.)

*Present law*

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to two years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of S corporation pursuant to a will.

*House bill*

The House bill expands the post-death holding period to two years for all testamentary trusts.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 4. FINANCIAL INSTITUTIONS PERMITTED TO HOLD SAFE HARBOR DEBT

(Sec. 1304 of the House bill and the Senate amendment.)

*Present law*

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt (“straight debt”) is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower’s discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

*House bill*

The definition of “straight debt” is expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 5. RULES RELATING TO INADVERTENT TERMINATIONS AND INVALID ELECTIONS

(Sec. 1305 of the House bill and the Senate amendment.)

*Present law*

Under present law, if the Internal Revenue Service (“IRS”) determines that a corporation’s Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.

*House bill*

Under the House bill, the authority of the IRS to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The House bill also allows the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. It is intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1982.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment. The conferees wish to clarify that in exercising the authority provided under the provision, the IRS may consider relevant information provided by any affected shareholder (including a person who became a shareholder in a subsequent year) before determining the validity of the S election for the taxable year in question.

## 6. AGREEMENT TO TERMINATE YEAR

(Sec. 1306 of the House bill and the Senate amendment.)

*Present law*

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

*House bill*

The House bill provides that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest is made by all affected shareholders and the corporation, rather than by all shareholders. The closing of the books applies only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

7. EXPANSION OF POST-TERMINATION TRANSITION PERIOD

(Sec. 1307 of the House bill and the Senate amendment.)

*Present law*

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The “post-termination period” is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation’s S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

*House bill*

The present-law definition of post-termination period is expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation’s election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of “determination” is expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the House bill repeals the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 8. S CORPORATIONS PERMITTED TO HOLD SUBSIDIARIES

(Sec. 1308 of the House bill and the Senate amendment.)

*Present law*

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

*House bill*

An S corporation is allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation is not allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake is not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

In addition, an S corporation is allowed to own a qualified subchapter S subsidiary. The term “qualified subchapter S subsidiary” means a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) for which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 9. TREATMENT OF DISTRIBUTIONS DURING LOSS YEARS

(Sec. 1309 of the House bill and the Senate amendment.)

*Present law*

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of property.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.

In addition, if the S corporation has accumulated earnings and profits, any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

*House bill*

The House bill provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The House bill also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 10. TREATMENT OF S CORPORATIONS UNDER SUBCHAPTER C

(Sec. 1310 of the House bill and the Senate amendment.)

*Present law*

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purpose of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). In 1988, the Internal Revenue Service took the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.<sup>33</sup> In 1992, the Internal Revenue Service reversed its position, stating that the prior ruling was incorrect.<sup>34</sup>

*House bill*

The House bill repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

<sup>33</sup> PLR 8818049, (Feb. 10, 1988).

<sup>34</sup> PLR 9245004, (July 28, 1992).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

11. ELIMINATION OF CERTAIN EARNINGS AND PROFITS

(Sec. 1311 of the House bill and the Senate amendment.)

*Present law*

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

*House bill*

The House bill provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits are solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 12. CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS UNDER THE AT-RISK RULES

(Sec. 1312 of the House bill and the Senate amendment.)

*Present law*

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

*House bill*

Losses of an S corporation that are suspended under the at-risk rules of section 465 are carried forward to the S corporation's post-termination period.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## 13. ADJUSTMENTS TO BASIS OF INHERITED S STOCK TO REFLECT CERTAIN ITEMS OF INCOME

(Sec. 1313 of the House bill and the Senate amendment.)

*Present law*

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her method of accounting. IRD is includible in the income of the person acquiring the right to receive such item.

A deduction for the estate tax attributable to an item of IRD is allowed to such person (sec. 681(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as “stepped-up basis.” Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although S corporation income is taxed to its shareholders in a manner similar to the taxation of a partnership and its partners, no comparable regulation require a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

*House bill*

The House bill provides that a person acquiring stock in an S corporation from a decedent would treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock in an S corporation acquired from a decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

*Effective date.*—The provision applies with respect to decedent dying after the date of enactment.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

14. S CORPORATIONS ELIGIBLE FOR RULES APPLICABLE TO REAL PROPERTY SUBDIVIDED FOR SALE BY NONCORPORATE TAXPAYERS

(Sec. 1314 of the House bill and the Senate amendment.)

*Present law*

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if: (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a

government; and (3) the land has been held by the taxpayer for five years.

*House bill*

The House bill allows the present-law capital gains presumption in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships will apply to S corporation (Treas. reg. sec. 1. 1237-1(b)(3)).

*Effective date.*—The provision is effective for sales in taxable years beginning after December 31, 1996.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

15. CERTAIN FINANCIAL INSTITUTIONS AS ELIGIBLE CORPORATIONS

(Sec. 1315 of the Senate amendment.)

*Present law*

A small business corporation may elect to be treated as an S corporation. A “small business corporation” is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An “ineligible corporation” means any corporation which is a member of an affiliated group, certain depository financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

*House bill*

No provision.

*Senate amendment*

A bank (as defined in sec. 581) is allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1996.

*Conference agreement*

The conference agreement follows the Senate amendment.

16. CERTAIN TAX-EXEMPT ENTITIES ALLOWED TO BE SHAREHOLDERS

(Sec. 1316 of the Senate amendment.)

*Present law*

A tax-exempt organization described in section 401(a) (relating to qualified retirement plan trusts) or section 501(c)(3) (relating to certain charitable organizations) cannot be a shareholder in an S corporation.

*House bill*

No provision.

*Senate amendment*

Tax-exempt organizations described in Code sections 401(a) and 501(c)(3) (“qualified tax-exempt shareholders”) are allowed to be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.

Items of income or loss of an S corporation will flow-through to qualified tax-exempt shareholders as unrelated business taxable income (“UBTI”), regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through to the qualified tax-exempt shareholders as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBTI.

In addition, certain special tax rules relating to employee stock ownership plans (“ESOPs”) will not apply with respect to S corporation stock held by the ESOP.

*Effective date.*—The provision applies to taxable years beginning after December 31, 1997.

*Conference agreement*

The conference agreement generally follows the Senate amendment. In addition, the conference agreement provides that if a qualified tax-exempt shareholder acquired, by purchase, stock in an S corporation (whether such stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution with respect to such S corporation stock (i.e., a distribution of subchapter C earnings and profits), except as provided in regulations the shareholder must reduce its basis in the stock by the amount of the dividend. Regulations may provide that the basis reduction only would apply to the extent the dividend is deemed to be allocable to subchapter C earnings and profits that accrued on or before the date of acquisition.

## 17. REELECTING SUBCHAPTER S STATUS

(Sec. 1315(b) of the House bill and sec. 1317(b) of the Senate amendment.)

*Present law*

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

*House bill*

For purposes of the five-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the proposal is not to be taken into account. Thus, any small business corporation that had terminated its S corporation election within the five-year period before the date of enactment may re-

elect subchapter S status upon enactment of the bill without the consent of the Secretary of the Treasury.

*Effective date.*—The provision is effective for terminations occurring in a taxable year beginning before January 1, 1997.

*Senate amendment*

Same as the House bill.

*Conference agreement*

The conference agreement follows the House bill and the Senate amendment.

## II. PENSION SIMPLIFICATION PROVISIONS

### A. SIMPLIFIED DISTRIBUTION RULES

(Secs. 1401–1404 of the House bill and the Senate amendment.)

*Present law*

In general, a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract (sec. 403(b) annuity)) generally is includable in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities.

*Lump-sum distributions*

Lump-sum distributions from qualified plans and qualified annuity plans are eligible for special 5-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee, second, after the employee attains age 59½, third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after 59½ may be made with respect to any employee.

Under the Tax Reform Act of 1986 (the "1986 Act"), individuals who attained age 50 by January 1, 1986, can elect to use 10-year averaging (under the rates in effect prior to the 1986 Act) in lieu of 5-year averaging. In addition, such individuals may elect to retain capital gains treatment with respect to the pre-1974 portion of a lump sum distribution.