Researchers estimate that the value of care giving responsibilities regularly assumed by family members and friends exceeded $200 billion in 1997. In comparison, federal spend- ing for formal home care in 1997, was $32 bil- lion, with an additional $83 billion for nursing home care.

Informal or family-care givers provide more long-term care and support, free of charge and with limited support, than the federal gov- ernment in all settings combined.

The obvious question becomes: how about paying or providing relief to the informal or family-care giver? I am taking steps to do just that by introducing legislation to amend the In- ternal Revenue Code of 1986 to provide a $1,200.00 tax credit for care givers of individ- uals with long-term care needs.

A $1,200.00 tax credit is the logical first step designed to recognize and compensate care givers for the long-term cost associated with informal or family-care giving.
and the vast majority of these are small businesses. The Subchapter S Modernization Act of 2001 is targeted to these small businesses by improving access to capital, preserving family-owned businesses, and lifting burdensome restrictions that unnecessarily impede their growth.

Even after the relief provided in 1996, S corporations face substantial obstacles and limitations that impose higher costs than other forms of entities. The rules governing S corporations need to be modernized to bring them more on par with partnerships and limited liability companies. For instance, S corporations are unable to attract the senior equity capital needed for their survival and growth. This bill would remove this obstacle prohibition and also provide that S corporations can attract needed financing through convertible debt.

Additionally, the bill helps preserve family-owned businesses by counting all family members as one shareholder for purposes of S corporation eligibility. The bill also increases the limit on the number of shareholders from 75 to 150. Also, nonresident aliens would be permitted to be shareholders under rules like those now applicable to partnerships.

The Subchapter S Modernization Act of 2001 includes the following provisions to help: improve capital formation opportunities for small businesses, preserve family-owned businesses, and eliminate unnecessary and unwarranted traps for taxpayers.

**Title I—Eligible Shareholders of an S Corporation**

**Section 101. Members of Family Treated as One Shareholder**

The Act provides for an election to count family members that are not more than six generations removed from a common ancestor as one shareholder for purposes of the number of shareholder limit (currently 75 shareholders). The election requires the consent of a majority of all shareholders. The provision enhances an S corporation's ability to expand into international markets and expands an S corporation's access to capital.

**Section 102. Nonresident Aliens Allowed to be Shareholders**

The Act would permit nonresident aliens to be S corporation shareholders. To assure collection of the appropriate amount of tax, the Act requires the S corporation to withhold and pay a tax on effectively connected income allocable to its nonresident alien shareholders. The provision enhances an S corporation's ability to expand into international markets and expands an S corporation's access to capital.

**Section 103. Expansion of Bank S Corporation Eligible Shareholders to Include IRAs**

The Act permits Individual Retirement Accounts (IRAs) to hold stock in a bank that is an S corporation. Additionally, the Act would exempt the sale of bank S corporation stock in an IRA from the prohibited transaction rules. Currently, IRAs own community bank stock, which results in a significant obstacle to banks that want to make an S election and take advantage of their access to capital.

**Section 104. Increase in Number of Eligible Shareholders to 150**

Currently a corporation is not eligible to be an S corporation if it has more than 75 shareholders. The Act increases the number of permitted shareholders to 150. The provision will enable S corporations to raise more capital and plan for the future without endangering their S corporation status.

**Title II—Qualification and Eligibility Rules**

**Section 201. Issuance of Preferred Stock Permitted**

The Act would permit S corporations to issue qualified preferred stock (QPS). QPS generally would be issued (i) to an entitling to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (iii) bears redemption or liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). Stock would not fail to be treated as QPS merely because it is convertible into other stock. This provision increases access to capital from investors who insist on having a preferential return and increases S corporation liquidity by permitting the older generation of shareholders to relinquish control of the corporation but maintain an equity interest.

**Section 202. Safe Harbor Expanding to Include Debt**

The Act permits S corporations to issue debt that may be converted into stock of the corporation provided that the terms of the debt are substantially the same as the terms that could have been obtained from an unrelated party. The Act also expands the current law safe-harbor debt provision to permit nonresident alien individuals as creditors. The provision facilitates the raising of investment capital.

**Section 203. Repeal of Excessive Passive Investment Income as a Termination Event**

The Act would repeal the rule that an S corporation would lose its S corporation status if it has passive income for three consecutive years. A corporate-level “sting” (or double) tax would still apply, as modified in Section 204 below, to excess passive income.

**Section 204. Modifications to Passive Income Rules**

The Act would increase the threshold for taxing excessive passive income from 25 percent to 60 percent (consistent with a Joint Tax Committee recommendation on simplification measures). In addition, the Act removes gains from the sales or exchanges of stock or securities from the definition of passive investment income for purposes of the sting tax.

**Section 205. Stock Basis Adjustment for Certain Charitable Contributions**

Current rules discourage charitable gifts of appreciated property by S corporations. The Act would remedy this problem by providing for an increased basis to shareholders stock in an amount equal to excess of the value of the contributed property over the basis of the property contributed. This provision conforms the section’s rules to those applicable to charitable contributions by partnerships.

**Title III—Treatment of S Corporation**

**Section 301. Treatment of Losses to Shareholders**

In the case of a liquidation of an S corporation, current rules can result in double taxation because of a mismatch of ordinary income and capital loss (recognized at the shareholder level on the liquidating distribution). Although capital tax planning can largely negate this result, many S corporations do not have the benefit of sophisticated tax advice. The Act eliminates this potential trap by providing that any portion of any loss recognized by an S corporation shareholder on an amount received by the shareholder in a complete liquidation of the S corporation would be treated as ordinary loss to the extent of the shareholder’s ordinary income basis in the S corporation stock.

**Section 302. Transfer of Suspended Losses Incident to Divorce**

The Act allows for the transfer of a pro rata portion of the suspended losses when an S corporation stock is transferred, in whole or in part, incident to divorce. Under current IRS regulations, any suspended losses or deductions are personal to the shareholder and cannot, in any manner, be transferred to another person. Accordingly, if a shareholder transfers all of his or her stock in an S corporation to his or her former spouse, as a result of divorce, any suspended losses or deductions with respect to such stock are permanently disallowed. This result is inequitable and unduly harsh and needlessly complicates property settlement negotiations.

**Section 303. Use of Passive Activity Loss and At-Risk Amounts by Qualified Subchapter S Trust Incapable of S Corporation Status**

The Act clarifies that, if a QSST transfers its entire interest in S corporation stock to an unrelated party in a fully taxable transaction, the income beneficiary’s suspended losses from an S corporation activity under the passive activity loss rules would be freed up for use by the income beneficiary.

The Act further provides that the income beneficiary’s at-risk amount with respect to an S activity would be increased by the amount of gain recognized by the QSST on a disposition of S stock. These provisions clarify a troublesome area under current law, and so, eliminate traps for the unwary taxpayer.

**Section 304. Deductibility of Interest Expense Incurred by an Electing Small Business Trust to Acquire S Corporation Stock**

The Act provides that interest expense incurred by an ESST to acquire S corporation stock is deductible by the S portion of the trust. Recently, proposed regulations would provide that interest incurred by an ESST to acquire stock in an S corporation is allocable to the S portion of the trust, but is not deductible. This result is contrary to the treatment of other taxpayers, who are entitled to deduct interest incurred to acquire an interest in a pass through entity. Further, Congress never intended to place ESSTs at a disadvantage relative to other taxpayers.

**Section 305. Disregard of Unexercised Powers of Appointment in Determining Potential Current Beneficiaries of ESST**

The Act revises the definition of a “potential current beneficiary” in the context of the ESST eligibility rules by providing that powers of appointment should only be evaluated at the point of the power’s exercisable. Current law provides that postponed or non-exercisable powers will not interfere with the making of an ESST election. However, proposed regulations provide that, once such powers become exercisable, the S election will automatically terminate if the power could potentially be exercised in favor of an ineligible individual—was actually exercised in favor of the ineligible individual or not. The application of this rule
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would prevent many family trusts from qualifying as ESOPs. The Act expands the existing method to cure a potential current beneficiary problem. Under the Act, an ESOP will have a period of up to one year (or 90 days to either dispose of all of its S stock or otherwise cause the ineligible potential current beneficiary's position in the trust to be eliminated without causing the ESOP election or the corporation's S election to fail.

SECTION 306. CLARIFICATION OF ELECTING SMALL BUSINESS TRUST DISTRIBUTION RULES

The Act clarifies that, with regard to ESOP distributions, separate share treatment will apply to the S and non-S portions under section 403(c).

SECTION 307. ALLOWANCE OF CHARITABLE CONTRIBUTIONS DEDUCTION FOR ELECTING SMALL BUSINESS TRUSTS

The Act permits a deduction for charitable contributions made by an ESOP, while taxing the charity on its share of the S corporation's income as unrelated business taxable income pertinent to the S election. The Act encourages philanthropy by permitting a charitable deduction while at the same time effectively taxing the S corporation's income in the hands of the recipient charity to the extent of the deduction.

SECTION 308. SHAREHOLDER BASIS NOT INCREASED BY INCOME DERIVED FROM CANCELLATION OF S CORPORATION'S DEBT

The Act provides that cancellation of indebtedness (COD) income excluded from the gross income of an S corporation, i.e. due to the S corporation's insolvency, does not increase shareholder's basis in S corporation stock. The Act changes the result reached in the recent U.S. Supreme Court decision in Gitlitz v. Comm'r (2000).

SECTION 309. BACK-TO-BACK LOANS AS INDEBTEDNESS

The Act clarifies that a back-to-back loan (a loan made to an S corporation shareholder who in turn loans those funds to his S corporation) constitutes "indebtedness of the S corporation to the shareholder" so as to increase such shareholder's basis in the S corporation.

SECTION 310. EXCLUSION OF INVESTMENT SECURITIES FROM PASSIVE INCOME TEST FOR ESOP, QSUB, AND S CORPORATIONS

The Act clarifies that interest and dividends on investments maintained by a bank for liquidity and safety and soundness purposes will not be "passive" income. By treating all bank income as earned from the active and regular conduct of a banking business, banks will no longer face the conundrum that their investment earnings based on tax considerations rather than on more important safety and economic soundness issues.

SECTION 311. TREATMENT OF QUALIFYING DIRECTOR SHARES

The Act clarifies that qualifying director shares of bank and notional stock in the S corporation will be allocated to these qualifying director shares. The provision clarifies the law and removes a significant obstacle unique among banks contemplating a S corporation election.

SECTION 312. BAD DEBT CHARGOFFS IN YEARS AFTER ELECTION YEAR TREATED AS ITEMS OF BUILT-IN LOSS

The Act permits bank S corporations to recapture up to 100 percent of their bad debt reserves on their first S corporation tax return and/or their last C corporation tax return to the effective date of the S election. Banks that convert to S corporation status must change from the reserve method of accounting to the specific charge off method. The result is recapture income is treated as built-in gain subject to tax at both the shareholder and the corporate level. The Act allows banks to accelerate the recapture of bad debt reserve in their last C corporation tax year. The corporate level tax would still be paid on the recapture income, but the recapture would no longer trigger a tax for the bank shareholders.

TITLE V—QUALIFIED SUBCHAPTER S SUBSIDIARIES

SECTION 501. RELIEF FROM INADVERTENTLY INVALID QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTIONS AND TERMINATIONS

The Act provides statutory authority for the Secretary to grant relief for invalid QSub elections, and terminations of QSub status, if the Secretary determines that the circumstances resulting in ineffectiveness or termination were inadvertent. This would allow the IRS to provide relief in appropriate cases, just as it currently does in the case of invalid or terminated S corporation elections.

SECTION 502. INFORMATION RETURNS FOR QUALIFIED SUBCHAPTER S SUBSIDIARIES

The Act would help clarify that a Qualified Subchapter S Subsidiary (QSSS) can provide information returns under their own tax ID number to help avoid confusion by employers, depositors, and other parties.

SECTION 503. TREATMENT OF THE SALE OF INTEREST IN A QUALIFIED SUBCHAPTER S SUBSIDIARY

The Act clarifies that a sale of an interest in a QSSS should be a simple matter. The doctrine respecting the treatment of QSSS's interest as if it were a separate corporation applies equally to S corporation and C corporation subsidiaries.

SECTION 504. ELIMINATION OF ALL EARNINGS AND PROFITS AND FOREIGN TAX CREDIT CARRYFORWARDS

The Act makes clear that any gain or income from an intercompany transaction is not taxed at the time of the S corporation or QSub elections.

SECTION 505. TREATMENT OF CHARITABLE CONTRIBUTION CREDIT AND FOREIGN TAX CREDIT CARRYFORWARDS

The Act provides that charitable contributions carryforwards and other carryforwards arising from a taxable year for which the corporation was a C corporation shall be allowed as a deduction against the net recognized built-in gain of the corporation for the taxable year. This is consistent with the legislative history of the 1986 Act.

SECTION 506. DISTRIBUTION BY AN S CORPORATION TO AN EMPLOYEE STOCK OWNERSHIP PLAN

An ESOP will usually borrow from the sponsoring corporation to fund its acquisition of employer securities. In the case of a C corporation, the tax code provides that an ESOP will not be treated as engaging in a "prohibited transaction" if it uses any "dividend" on employer securities purchased with loan proceeds to make payments on the loan regardless of whether such employer securities have been pledged as collateral to secure the loan. The policy facilitates the payment of ESOP loans and thereby promotes employee ownership. Because S corporation distributions are technically not "dividends", the Act provides that S corporation distributions are treated as dividends. This clarification is necessary to ensure that the policy of facilitating the payment of ESOP loans applies equally to S corporation and C corporation ESOPs.

SECTION 507. SPECIAL RULES OF APPLICATION

The effective dates of some amendments made by the Act may occur in years in which it is too late to file a claim for refund arising in such years from applying the amendments. The Act grants a 1-year extension beginning on the date of enactment which to file such claims for these closed years.

Mr. Speaker, I urge my fellow members to review and support the S Corporation Modernization Act, which will help create a level playing field for small businesses. I look forward to working with my colleagues on the Ways and Means Committee to enact this bill.