S CORPORATION MODERNIZATION ACT OF 2011
Summary of Provisions

Section 1 -- Short Title

S Corporation Modernization Act of 2011

Section 2 -- Extension of Current Law: Built-In Gains

Prior to 2009, businesses converting to S corporation were required to hold on to any assets with built-in gains (BIG) for at least 10 years or face a punitive tax applied at the highest corporate rate. This tax is applied on top of other applicable federal, state and local taxes and effectively precludes these businesses from accessing this critical source of capital.

In 2009, Congress enacted the 2009 American Recovery and Reinvestment Act which reduced the holding period to 7 years. This shorter holding period was set to expire at the end of 2010.

In September of 2010, Congress again enacted legislation reducing the BIG holding period. The Small Business Jobs Act of 2010 temporarily reduced the holding period to five years to help even more S corporations access their own capital. This five year holding period expires for tax years beginning after December 31, 2011.

The S Corporation Modernization Act would make this 5-year holding period permanent.

- As private, closely-held businesses, S corporations have less access to credit and the capital markets than their publicly-held competitors. The BIG tax exacerbates this disadvantage by preventing recently converted S corporations from putting the capital they already control to better use.

- S corporations should not be blocked from accessing their own capital; these are critical resources to allow private companies to grow their businesses, create jobs and remain competitive in today's global economy without being forced to borrow unduly.

- The provision does not repeal the BIG tax itself; it merely reduces the period for which assets must be held to one that is reflective of today's business cycles, thus preserving the original policy intent of the rule.

(Related Legislation: P.L. 111-240 Section 2014, P.L. 111-5 Section 1251, H.R. 2910 Section 2, S. 996 Section 2 – 111th Congress; H.R. 4840 Section 2, H.R. 3874, S. 3063 Section 2 – 110th Congress)

Section 3 -- Modification to Passive Income Rules

The excess passive investment tax, also referred to as the "Sting 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% passive income threshold.

The provision would raise the Sting Tax threshold to 60 percent of gross receipts and is consistent with recommendations made by the Joint Committee on Taxation in their 2001 tax simplification report.

- 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.

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

Section 4 -- Repeal Excess Passive Investment Income as a Termination Event

Under current law, a firm that has converted to S corporation status may lose that status if it has excess passive income for three consecutive years.

This provision would eliminate this “three years and out” restriction and is consistent with recommendations made by the Joint Committee on Taxation in their 2001 tax simplification report.

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

Section 5 -- Expansion of Qualifying Beneficiaries of an Electing Small Business Trust

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 individual to be an eligible beneficiary of an ESBT.

- 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” by a potential beneficiary of an ESBT becoming a nonresident alien.

- The provision will not allow for tax avoidance. 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: H.R. 2910 Section 5, S. 996 Section 5 – 111th Congress; H.R. 4840 Section 3; H.R. 1591 Sec. 526 of the Senate-passed version of the Small Business Tax Package, S. 3063 Section 5 – 110th Congress)

Section 6 -- S Corporation IRA Shareholders

Current law allows an IRA to be a shareholder in an S corporation provided the S corporation is a bank or savings institution holding company. The IRA shareholder must have been a shareholder in the bank or related holding company prior to its conversion to S corporation status and any income attributed to the IRA shareholder from the S corporation is subject to the unrelated business income tax (UBIT).

The provision would allow IRAs to hold stock in all S corporations, consistent with current law treatment for S corporation banks.

- Congress has already reformed S corporation rules to allow those in the banking industry to have IRA shareholders. The policy rationale for this modification has been accepted. This provision would simply extend the policy to other sectors so that companies in non-banking businesses would not be treated differently.

- If an employee owns shares in the S corporation and rolls those shares into an IRA without realizing that S corporation rules prohibit IRA shareholders, the S corporation could lose its S election. The result would be punitive tax charges and months or years in IRS negotiations and uncertainty for all the shareholders of the S corporation. This provision would eliminate this pitfall.

(Related Legislation: H.R. 2910 Section 6, S. 996 Section 6 – 111th Congress; H.R. 4840 Section 6; S. 3063 Section 6 – 110th Congress)

Section 7 -- Charitable Contributions for ESBTs

Current law does not allow electing small business trusts to claim a deduction for certain charitable contributions attributed to an S corporation within the trust, 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: H.R. 2910 Section 7, S. 996 Section 7 – 111th Congress; H.R. 4840 Section 7, S. 3063 Section 7, and Sen. Cardin amendment offered to Senate Small Business Package H.R. 1591 - 110th Congress)

Section 8 -- Extension of Current Law: Charitable Contributions of Property

Under the Pension Protection Act (PPA) of 2006, if an S corporation makes a contribution to charity, shareholders reduce the basis in their S corporation stock in an amount equal to the shareholder's pro rata share of the adjusted basis of the contributed property. Previously, shareholders reduced the basis in their stock by their pro rata share of the fair market value of the contribution.

The Emergency Economic Stabilization Act extended the current rules through the end of 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the provision through the end of 2011.

The S Corporation Modernization Act would make this adjustment permanent.

- The provision would permanently extend the ability for shareholders to take into account their pro rata share of charitable deductions even if such deductions would exceed such shareholder's adjusted basis in the S corporation.

- The provision would allow for America's S corporations to be more active and supportive of needed charitable activities.

(Related Legislation: P.L. 111-312 Section 752, H.R. 2910 Section 8, S. 996 Section 8 - 111th Congress; P.L. 110-343 Section 307 – 110th Congress)