

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**Tax Reform Recommendations on
Small Businesses, Partnerships and S Corporations**

**Submitted to the House Committee on Ways & Means
Tax Reform Working Group on Small Business/Passthroughs**

April 2013

**AICPA's Tax Reform Recommendations on
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Proposal: Provide parity for employees and self-employed individuals in regards to the tax treatment of health insurance costs under the Self-Employment Contributions Act

Present Law

The Self-Employment Contributions Act (SECA) of 1954 imposes tax on the net earnings from self-employment. The tax is composed of two parts: old-age, survivors and disability insurance (OASDI) tax and hospital insurance (HI) tax. Section 162(l)(4) provides that self-employed individuals are not allowed to deduct the cost of their health insurance costs from net earnings from self-employment (within the meaning of section 1402) in determining tax under section 1401(a) and section 1401(b) for old-age, survivors and disability insurance and hospital insurance. However, pursuant to section 3121(a)(2), health insurance costs are excluded from an employee's wages in determining tax under section 3101(a) and 3101(b) for OASDI and HI taxes.

Description of Proposal

Equalize the tax treatment with respect to the deduction for health insurance costs in determining income subject to OASDI and HI taxes as was allowed temporarily under the Small Business Jobs Act of 2010.

Analysis

Deductions allowable in determining a particular tax should be consistent amongst taxpayers subject to such tax. Employees subject to OASDI and HI taxes are allowed a deduction for health insurance costs in determining their net income subject to these taxes while self-employed individuals subject to these same taxes are not allowed a deduction in determining their net income subject to these taxes.

Conclusion/Recommendation

It is recommended that deductions allowed in determining income subject to OASDI and HI taxes be consistent amongst taxpayers regardless of whether they are employees or self-employed individuals.

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Proposal: Allow transfers of partnership suspended losses between spouses and former spouses upon a section 1041(a) exchange

Present Law

Section 1366(d)(2)(B) of the Internal Revenue Code permits an S corporation shareholder to transfer suspended losses to his/her spouse when a section 1041(a) exchange takes place between spouses or incident to a divorce. No such transfer between spouses or former spouses is permitted for the suspended losses of partners in partnerships.

Description of Proposal

Husbands and wives engaged together in the operation of a partnership may transfer partnership units to each other under section 1041(a) or incident to a divorce. When such a transfer occurs, suspended losses of the transferor spouse will now be treated as incurred by the partnership in the succeeding taxable year with respect to the transferee spouse.

Analysis

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position in which husband and wife shareholders of an S corporation were prior to the addition of section 1366(d)(2)(B). That is, after the transfer, they find that suspended losses of the transferor are now trapped, forever unusable.

Conclusion/Recommendation

Suspended losses should be made available to the spouse who actually owns the partnership interest, regardless of who was entitled to the suspended loss prior to the transfer of ownership interest. This recommendation furthers the tax policy goals of simplicity and equity.

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Proposal: Clarify that husband and wife partnerships that are recognized under state law are eligible to elect qualified joint venture (QJV) status under section 761(f)

Present Law

The Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28 added section 761(f) to simplify the tax reporting requirements of a husband and wife partnership by treating it as two sole proprietorships. The only statutory requirements are that (1) the husband and wife both materially participate in the business, (2) they file a joint return, (3) they are the only members of the joint venture and (4) they elect not to be treated as a partnership.

On its website, the IRS has published a definition of a qualified joint venture under 761(f), which indicates that it “includes only businesses that are owned and operated by spouses as co-owners, and not in the name of a state-law entity (including a general or limited partnership or a limited liability company)...” and also notes that “...mere joint ownership of property that is not a trade or business does not qualify for the election.”

Description of Proposal

The husband and wife joint venture election under section 761(f) should be clarified to cover state law general and limited partnerships and limited liability companies. To accomplish this result, a modification to section 761(f)(2) could be made by adding a flush sentence after subparagraph (C) that reads:

The qualified joint venture shall not be disqualified from making the election of the subsection merely because the ownership interests are held through a state law entity such as a partnership or limited liability company.

Analysis

The administrative limitation on state law entities makes it hard to imagine which, if any, husband-wife partnerships are able to take advantage of this potential simplification. The state law rules governing partnerships and limited liability companies are typically based on the Revised Uniform Partnership Act, the Revised Uniform Limited Partnership Act or the Uniform Limited Liability Company Act as adopted by a particular state but which typically defines a partnership as two persons engaged in an activity for profit and treats even a general partnership as a state law entity. Such a definition would bring virtually all husband and wife business operations under state law jurisdiction and would thus disqualify them from electing QJV status.

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Conclusion/Recommendations

Congressional clarification of section 761(f) is needed. If Congress would like to achieve the simplification it contemplated when it enacted this election, it must specifically allow husband and wife partnerships (including the popular limited liability company, but minimally the general partnership) to make this election.

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Proposal: Allow an offset to the built-in gains (BIG) tax for charitable contribution and foreign tax credit carryforwards from a C year

Present Law

Generally, section 1371(b) prohibits the carryover of deductions and credits from a C year to an S year. However, sections 1374(b)(2) and (b)(3)(B) allow certain exceptions so that net operating loss and capital loss carryforwards, as well as section 39 general business and section 53 minimum tax credit carryforwards from C years are permitted to offset the net recognized built-in gain of an S corporation. No such deduction from or credit against the net unrecognized built-in gain of an S corporation is permitted for charitable contribution or foreign tax credit carryforwards.

Description of Proposal

Section 1374(b)(2) would be modified to add charitable contribution carryforwards from a C year to the items that can be deducted against the net recognized built-in gain of an S corporation.

Section 1374(b)(3)(B) would be modified to add section 27 foreign and possessions tax credit carryforwards to the items allowed as a credit against the net recognized built-in gain of an S corporation. An alternative way to achieve the same result is to modify section 39(b) to include the foreign tax and possession tax credits among the current year general business credits permitted to be carried forward from a C year to an S year.

Analysis

It would seem equitable that all deduction and credit carryforwards arising in a C year be allowed to reduce the corporate-level built-in gain tax of an S corporation since both the carryforwards and the BIG tax relates to a liability integrally related to the former C corporation. It appears that the foreign credits may have been omitted simply as an oversight due to their lack of inclusion in the general business credit regime.

Conclusion/Recommendation

The law should allow deductions and credits against the section 1374 BIG tax for charitable contribution and foreign and possessions tax credit carryforwards arising in a C year.

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Proposal: Add a new 120-day Post-Termination Transition Period (PTTP) beginning on the date that a taxpayer files an amended Form 1120S

Present Law

Section 1377(b) defines a post-termination transition period in one of three ways, each of which occurs after a termination of the S election. The first PTTP begins the day after the last S year ends and ends the later of one year or the extended due date of the return. The second period begins on the date an IRS adjustment is made and lasts for 120 days. The third period begins on the date an IRS determination is made that the S election had terminated for a previous year and lasts for 120 days. Sections 1366(d)(3) and 1371(e) describe the major benefits of the PTTP as allowing a shareholder to adjust stock basis, utilize suspended losses and take tax-free distributions to the extent of both AAA and basis through the end of the PTTP as though the S corporation election were still valid.

Description of Proposal

A fourth PTTP would be added such that a 120-day PTTP would begin on the date that an amended return (Form 1120S) is filed if (1) the filing occurs after the S period ends; (2) if such 120-day period would lengthen the initial [generally] one-year PTTP and (3) if the amended return adjusts any item of income, loss or deduction arising during the S period. This new PTTP would be accomplished by the addition of new subparagraph 1377(b)(1)(D) as follows:

- (D) the 120-day period beginning on the date an amended return has been filed for any S year, having been so filed after the termination of the corporation's election, and which amended return 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)).

Conforming amendments would be made to subparagraphs (A) and (B) of section 1377(b)(3) by replacing the language "Paragraph (1)(B)" with "Paragraphs (1)(B) and (D)" each place it appears. In addition, the heading for section 1377(b)(3) would be modified to read "Special rules for audit and amended return related post-termination transition periods."

Analysis

We believe the source of adjustments to S items, whether by IRS audit or by the taxpayer, should be immaterial when it comes to obtaining the benefits of a PTTP. When a tax return is corrected because of taxpayer oversight, error, judicial clarification, or another reason, the corrected return should be the basis for determining AAA, the taxability of distributions, shareholder basis and other items that are relevant during the PTTP and, therefore, the filing of an amended return should also trigger the beginning of a new PTTP, as occurs in the case of an audit adjustment.

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Conclusion/Recommendation

The reason for adjustments to S items, whether by audit or taxpayer redetermination on an amended Form 1120S, is immaterial to the policy behind a PTTP. Accordingly, a 120-day PTTP should begin upon the filing of an amended Form 1120S.

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Proposal: Allow S corporations to have nonresident aliens as shareholders and potential current beneficiaries of electing small business trusts¹

Present Law

Section 1361(b)(1)(C) of the Internal Revenue Code provides that a nonresident alien is not eligible to be a shareholder of an S corporation. Reg. section 1.1361-1(m)(1)(ii)(D) and -1(m)(5)(iii) require that a potential current beneficiary (PCB) of an electing small business trust (ESBT) must be an eligible S corporation shareholder. Thus under current statute, nonresident aliens are not permitted shareholders and under current regulations, they are not permitted PCBs. If a nonresident alien becomes a PCB of an ESBT, the S corporation's election will terminate.

Description of Proposal

Allow nonresident aliens to be shareholders of an S corporation and require the S corporation to withhold and pay a withholding tax for its nonresident alien shareholders. Also permit nonresident aliens to become PCBs of an ESBT.

Analysis

Nonresident aliens should be allowed as shareholders and as potential current beneficiaries of electing small business trusts. Nonresident aliens are able to contribute capital to and participate in the benefits and obligations of an S corporation indirectly in instances where the S corporation is aware that such result can be obtained and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships; the operating partnerships, in turn, permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive passthrough items from the S corporation's operations. If nonresident aliens were permitted to be direct owners of S corporations, they would be subject to withholding just as nonresident alien partners are, thus protecting against revenue loss at the individual level. Such direct ownership benefits should not be available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should also be free to raise capital from these individuals.

With regard to nonresident aliens as PCBs of an ESBT, because the trust pays tax at the highest rates, there is no policy reason for restrictions on the types of allowable ESBT potential current beneficiaries.

Conclusion/Recommendation

¹ See Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities, section 233 (March 12, 2013).

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Section 1361(b) should be amended to allow a nonresident alien to be an eligible shareholder of an S corporation. In conformity with that change, section 1446 should be amended to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation's nonresident alien shareholders. A nonresident alien should also be a permitted potential current beneficiary of an electing small business trust.

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Proposals: Repeal section 1362(d)(3), which terminates an S election due to passive investment income that exceeds a certain threshold, or increase the passive investment income (PII) threshold of S corporations under section 1375(a)(2) from 25 percent to 60 percent.²

Present Law

Section 1375 imposes the highest corporate rate of tax (currently 35 percent) on the royalties, rents, dividends, interest and annuities earned by certain S corporations if such revenue sources, net of allowable deductions, exceed 25 percent of the corporation's gross receipts and if the corporation has accumulated earnings and profits from a former C year at the close of the tax year. There are exceptions to this rule for certain income of banks and bank holding companies, finance companies, interest from installment sales of inventory and dividends from certain C corporation stock. An S corporation may avoid the tax by distributing its AE&P before the close of the tax year.

Section 1362(d) penalizes an S corporation with involuntary termination of its S election if the tax under section 1375 is imposed for three consecutive years.

Description of Proposals

Eliminating the termination event

Section 1362(d)(3) should be repealed in its entirety, thus preventing the threat of an involuntary termination of the S election related to passive investment income.

Raising the PII thresholds

Sections 1375(a)(2) and (b)(1)(A)(i) (as well as the section 1375 header), and (to the extent not repealed) section 1362(d)(3)(A)(i)(II) (as well as the section 1362(d)(3) header) would be modified to replace "25 percent" with "60 percent" each place it appears. This change would have the effect of raising the threshold for the imposition of the tax on excess net passive investment income.

Analysis

The apparent, although unstated, goal of the excess net passive investment income tax and termination of the S election is to penalize an S corporation for a failure to distribute the accumulated earnings and profits of a C corporation predecessor. Given this apparent goal, it is unclear what the connection is between those undistributed earnings and profits and the passive investment income of the S corporation. If the tax is intended to encourage distributions of C corporate earnings and profits, then why not tax the earnings

² See Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities, section 232 (March 12, 2013).

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and profits under a concept similar to the accumulated earnings tax of sections 531-537? We recommend that Congress draft a similar regime that is appropriate under subchapter S. If the current regime is to be maintained, it should at least minimize the differential between a hypothetical, yet correlated tax on accumulated earnings and profits and the uncorrelated tax currently imposed on excess net PII.

While encouraging distributions of accumulated earnings and profits appears to be the primary goal of sections 1375 and 1362(d)(3), a logical by-product of the sting tax regime is to discourage the earning of passive investment income by S corporations since the tax is, in fact, imposed on and triggers a termination based on PII. However, it is impossible that discouraging an S corporation from earning PII was the sole goal of the original lawmakers since the regime only applies to S corporations with accumulated earnings and profits. Accordingly, as a matter of fairness, and to better fit the "punishment" with the "crime," the termination event should be repealed or made to impact fewer taxpayers. These measures would be a positive first step.

Conclusion/Recommendation

Section 1362(d)(3) should be repealed to eliminate a significant uncertainty for S corporation operations, thereby preventing an involuntary termination of S status caused by excess passive investment income. If repealing section 1362(d)(3) is not feasible, Congress should eliminate the impact of the "sting tax" by modifying sections 1362(d)(3) and 1375 and replace "25 percent" with "60 percent" each time it appears, thereby taxing an S corporation's passive investment income in an analogous fashion to imposition of the personal holding company tax on C corporations. Enactment of either measure would enable an S corporation to earn large amounts of passive investment income without loss of its S status or fear of a corporate tax.