Stop S-Corporation Sales Discrimination

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S-Corporations are the only entities that owners, partners or shareholders cannot sell to benefit favored charities by using a Charitable Remainder Trust (CRT). Presently, there are approximately 6 million S-Corporations in America awaiting retirement, hoping for a change in the tax law to allow them to be on the same playing field other types of business entities employ. The purpose of this article is to trace the beginnings of S-Corporations to see how this discrimination actually began and to explore the tax on unrelated business taxable income (UBTI), which unfairly taxes a shareholder on selling S-Corporation stock inside a CRT. To further prevent this discrimination, this article will outline the minor changes necessary to modify this law.

Background of the S-Corporation Election:

Current Rules to Make an Election

To qualify, a corporation must:

- Be a domestic corporation (other than certain specified types of domestic corporations subject to certain special rules).
- Not have more than "one class of stock."
- Meet certain limitations on its shareholders. The Code imposes the following limits on who may own stock in an S-Corporation:
  - There must be 100 or fewer shareholders.
  - Shareholders can only be individuals, estates, certain types of trusts or tax-exempt entities.
  - Shareholders cannot be nonresident aliens.

A Brief History of Subchapter S

S-Corporations have been around for more than 55 years, but the relevant history is actually somewhat longer. "In 1946, a Treasury study proposed the possibility of a corporation that would be eligible to use a 'partnership method' of taxation, with many eligibility criteria similar to what would become Subchapter S: corporations with not more than some stated, fairly small number of individual stockholders (and no corporate stockholders), and with no more than one class of stock. A supplementary or alternative standard might be size of the corporation (probably measured in terms of assets). "(1)

"In 1954, President Eisenhower and the Senate each proposed a system by which certain corporations could elect to be treated as partnerships. Unlike the modern Subchapter S, this proposal would have treated electing corporations as partnerships for tax purposes, subject to the rules of Subchapter K." This would have had the virtue of not proposing a separate tax regime as we have today; instead, it would simply have allowed certain entities normally subject to Subchapter C to apply Subchapter K. The 1954 Senate proposal contained eligibility rules similar to Subchapter S as later first enacted (no more than ten individual owners, a bar on owners that are nonresident aliens and the requirement of a single class of stock)." (2)

"Subchapter S was enacted in 1958 to limit the influence of tax considerations on the choice of entity used to own a business and to provide tax relief for small businesses. Prior to the enactment of Subchapter S, business entities could be sole proprietorships, partnerships, or corporations, with tax considerations and commercial law considerations following the choice of entity. Corporations offered limited liability for all owners but were not taxed as pass-through Sole proprietorships and partnerships offered pass-through tax treatment but, at least for active participants in the business, offered no limited liability protection (at the time limited partnership statutes provided that limited partners who participated in the control of the partnership could lose their liability shield). *The S-Corporation was proposed in part to allow small businesses to have limited liability under non-tax law and to avoid corporate-level tax; to let 'businesses select the form of organization desired, without the necessity of taking into account major differences in tax consequences.'"*(3)

Subsequent Amendments

From 1958 until 1981, the amendments modestly liberalized the rules. Notably, the shareholder limit was raised from ten to 25 and estates of bankrupt shareholders along with certain trusts became eligible shareholders, but not trustees of CRT's. The rule that all new shareholders had to consent to an S-Corporation's election was amended so that the election would be revoked only if a new shareholder "affirmatively refused" consent within 60 days of becoming a shareholder. Corporate-level tax on an S-Corporation was first imposed in 1966; this tax applied to S-Corporations with more than a specified amount of capital gain.

In 1982, the "Subchapter S Revision Act" (SUSRA) made substantial structural changes to "simplify and modify the tax rules relating to eligibility for Subchapter S Status and the operation of Subchapter S-Corporations . . . by removing eligibility restrictions that appear unnecessary and revising the rules relating to income distributions, etc., that tend to create traps for the unwary." SUSRA fundamentally changed Subchapter S from the system described above to a "true" pass-through regime more similar to Subchapter K at the owner level.

After SUSRA, S-Corporation shareholders included their pro rata share of S-Corporation items on their personal tax returns, and the character of all tax items passed through (unless limited by tax basis). SUSRA also revised the rules relating to distributions to conform to the modern rule. Distributions from S-Corporations that do not have accumulated earnings and profits are first set against each shareholder's outside basis and then treated as gains from a sale or exchange.

SUSRA further broadened the eligibility rules by increasing the number of permitted shareholders to 35, amending the one class of stock rule to permit stock with different voting rights, and a safe harbor for "straight debt." The 1982 amendments also removed the restriction on excess foreign income and changed the criteria for excess passive income rules to the current rule.

After 1983, the amendments to Subchapter S and regulatory changes, while important, did not change the basic structure of Subchapter S. The Tax Reform Act of 1986 "repealed" *General Utilities Co. v. Helvering*; after 1986, corporations generally must recognize gain when distributing appreciated property.

In 1990 and 1991, Treasury and the Internal Revenue Service issued and revised proposed regulations relating to the one class of stock rule, which were finalized in 1992. This regulation has remained unchanged to the present day. These regulations first set out the general rule that a corporation has one class of stock if "all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds." The regulations go on to list a number of rules that determine whether specific arrangements or instruments are treated as a second class of stock. In many cases, the regulations include safe harbors that an S-Corporation can rely on.

In 1996, The Small Business Job Protection Act made a number of changes that broadened the scope of Subchapter S. S-Corporations gained the ability to own subsidiary corporations and a wholly owned domestic corporate subsidiary could elect to be treated as a QSSS. This eliminated "[a] major inefficiency of current law, the mandate that an S-Corporation operate through divisions even though business exigencies urge the creation of one or many subsidiaries."( ) This legislation increased the shareholder limit to 75 and allowed certain tax-exempt organizations and electing trusts as shareholders. For most tax-exempt investors, the tradeoff was that all income from an S-Corporation was taxed as unrelated business taxable income (UBTI), although this is not the case for ESOPs, which led to some large transactions. Finally, in 2004 and 2005, the number of permitted shareholders reached 100, and rules were added to treat certain members of a family as a single shareholder.

A Brief History on the UBIT on Exempt Organizations

Revenue Act of 1950

In the Revenue Act of 1950, the Congress enacted a tax on the unrelated trade or business income of certain otherwise tax-exempt organizations. Under the 1950 statute, the tax applied to charitable organizations (other than churches), trade associations, labor unions, and certain other categories of tax-exempt organizations.

The legislative history of the 1950 Act states that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition." It did not deny tax-exempt status (if otherwise available) solely because the organization carried on unrelated active business enterprises, but "merely imposes the same tax on income derived therefrom as is borne by their competitors." Court decisions have cited the legislative history of the 1950 Act as reflecting "the undisputed purpose of the unrelated business income tax was to prevent tax- exempt organizations from competing unfairly with businesses whose earnings were taxed."[5]

Tax Reform Act of 1969

In the Tax Reform Act of 1969, "Congress extended the UBIT to all organizations that are exempt from Federal income tax under section 50l(a), except certain U.S. instrumentalities created and made tax-exempt by a specific Act of Congress." As originally enacted, the UBIT had applied only to charitable, educational, religious, and other organizations (other than churches) tax-exempt under Code section 50l(c3); labor and agricultural organizations (sec. 50l(c5)); trade associations (sec.501(c6); qualified pension and profit-sharing trusts (sec. 401); and certain other types of tax-exempt entities. However, by 1969, the Congress found that many other categories of exempt organizations-including churches, social clubs, and fraternal beneficiary societies had begun "to engage in substantial commercial activity."[6]Congress concluded that there was no justification to tax (for example) a university or hospital on income from an unrelated trade or business, but not to tax a church or social club on income from the same types of activities.

Subsequent Legislation

While Congress has not engaged in an overall reexamination of the principal provisions of UBIT since 1969, subsequent legislation has modified UBIT in various respects. "These modifications have included providing exclusions from the UBIT (in the case of specified categories of exempt organizations) for income from (i) qualified trade show, convention, or State fair activities; (ii) providing certain hospital services; (iii) conducting bingo games; (iv) engaging in telephone pole rentals; (v) distribution of low-cost articles in soliciting charitable contributions; and (vi) certain exchanges or rentals of member or donor mailing lists. Other modifications have related to the debt-financed property rules, insurance activities of exempt organizations, and nonexempt function income of qualified trusts that are part of plans for payment of supplemental unemployment compensation benefits or for group legal services.''

Change That Is Needed

Based upon the legislative history of both the S-Corporation rules and the UBIT rules summarized above, the proposed changes in the law would not violate the spirit or intent of these rules. The original intent of the S-Corporation election was to provide businessmen with the ability to pass-through income much like a partnership with the added protection of the corporate structure. Consider, these laws came to pass before the concept of the Limited Liability Company (LLC) to provide liability protection for individual owners of a business. The change needed to amend IRC Section 1361(c) (2) (A) would be to add **"(vii) A charitable remainder trust described in Section 664."** This change would then permit a trustee of a CRT to own S-Corporation stock without the automatic termination of the S-Corporation election.

The second change needed to allow the sale of the S-Corporation's contributed stock to the CRT would be to change the Code Section 512 (e) (1) rules that apply to unrelated business taxable income. The additions would be in bold, "If an organization described in section 1361 (c)(2)(A)vi), 1361(c)(6) or 1361(c)(2)(vii) holds stock in an S-Corporation, the rules described in Section 512(c) pertaining to partnership shall apply to the income of the S-Corporation." This change does not change the spirit or intent of the UBIT rules for the taxing the income earned by an entity. Instead, it only exempts a charity, retirement plan and a CRT from paying the unrelated business income tax on investment income and on the capital gain from the sale of the investment. This would make the taxation of S Corp income more consistent with the general rules that govern UBTI compared to the harsh current law that applies to S corp income.

In summary, it is time to remove the discrimination of S-Corporation stock. Every other entity form in America that a business can operate in can use a CRT as an exit strategy. It is time to level the playing field for these businesses when sold. This will generate retirement income or other financial planning objectives for their business owner. The non-profits in America will benefit tremendously from these changes. It is time to change the tax law!

If you would like to join in with many other professionals to fight to change this law please log in to our website www.taxreformpac.org and add your name to the list of supporters!

End Notes:

1. Richard B. Goode, Treasury Department, The Post War Corporation Tax Structure 1946; Federal Income Taxation of S-Corporation, (4th edition 2001).
2. Staff of the Joint Comm. On Taxation, 83d Cong. Summary of the president's 1955 budget; H.R. 8300, 83rd Cong. {{1351 (as passed by Senate July 2, 1954.
3. S Rep. no 85-1983, at 87 (1958); see Eustice & Kuntz, Supra note 1.
4. See Tax Reform Act of 1986, Pub. L no 99-514,{{631(c), 100 stat. 2085,2271.
5. Overview of the unrelated business tax on exempt organization scheduled before the subcommittee on oversight of the House Committee on Ways and Means June 22,25,26,296 and 30, 1987 prepared by the staff of the Joint Committee on Taxation, June 20,1987.
6. H.rpt-91-413 (pt 1) 91st Congress., 1sy session 47 (1969);Sen rpt. 91-522, 91st Cong., 1st ses. 67 (1969).