



Statement of the U.S. Chamber of Commerce

**ON: S-CORPS: RECOMMENDED REFORMS THAT PROMOTE
PARITY, GROWTH AND DEVELOPMENT FOR SMALL
BUSINESSES"**

**TO: SUBCOMMITTEE ON FINANCE AND TAX OF THE HOUSE
COMMITTEE ON SMALL BUSINESS**

DATE: JUNE 18, 2008

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 105 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

**Statement for the record on
S-corps: Recommended Reforms that Promote Parity, Growth and
Development for Small Businesses
Hearing before the
SUBCOMMITTEE ON FINANCE AND TAX OF
THE HOUSE COMMITTEE ON SMALL BUSINESS
on behalf of the
U.S. CHAMBER OF COMMERCE
June 18, 2008**

Chairwoman Bean, Ranking Member Buchanan, and members of the Subcommittee, the U.S. Chamber of Commerce thanks you for the opportunity to comment on S corporation reform. The Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. The Chamber is particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

BACKGROUND

Over 3.6 million small business corporations in this country have elected to be treated as S corporations for federal income tax purposes.¹ Unfortunately, Subchapter S of the Internal Revenue Code has not kept pace with the realities of the modern business world. Its rules are outdated, restrictive, overly complex, and burdensome, which hinders the ability of small businesses to attract capital and grow to their full potential.

Subchapter S has undergone many changes since its inception in 1958. Various legislation altering this part of the tax code was enacted in 1982, 1984, 1986, 1996, 2004, 2005, and 2007.² Even though its rules have become increasingly complex and cumbersome, S corporations continue to grow in popularity. In 1978, S corporations made up only 3.1 percent of all business entities.³ By contrast, in 2005, S corporations constituted 11.6 percent of all business entities. Of these S corporations, approximately 63% have no more than \$100,000 in assets.⁴

¹ See Internal Revenue Service (IRS) Statistics of Income, available at www.irs.gov.

² See P.L. 97-354, P.L. 98-369, P.L. 99-514, P.L. 104-188, P.L. 108-357, P.L. 109-135, and P.L. 110-28.

³ See Staff of the Joint Committee on Taxation, Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity, JCX-48-08, June 5, 2008.

⁴ See Staff of the Joint Committee on Taxation, Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity, JCX-48-08, June 5, 2008.

S corporations have the dual advantages of being treated like partnerships for federal income tax purposes and providing the corporate feature of limited liability protection to its shareholders. S corporation shareholders, therefore, are subject to federal income tax on their share of corporate earnings only once (at the individual level), while being limited in liability to their amounts at-risk. In addition, almost all states recognize S corporations for income tax purposes. For these reasons, many small business owners have elected to structure their businesses as S corporations.

While many entities structured as S corporations achieve success, they also often encounter significant unforeseen economic and procedural disadvantages due to the restrictive rules and regulations which govern these entities. Obtaining outside capital and adhering to the maze of tax laws can be extremely difficult for many existing S corporations. C corporations that would otherwise elect S corporation status are dissuaded from doing so because of the growth-hindering and arcane rules currently in effect.

The rising popularity of limited liability companies (LLCs) over the past 15 years does not provide relief to many existing S corporations. In addition to being costly for many S corporations to convert to LLCs, the LLC is not necessarily the best type of entity for all small businesses.

Substantial reform is needed so S corporations can better compete in today's increasingly sophisticated and global economy. The U.S. Chamber appreciates the opportunity to address and suggest remedies for the multitude of problems that have plagued Subchapter S of the Internal Revenue Code since its inception.

RECOMMENDATIONS

The Chamber recommends updating many of the current S corporation rules and assisting in the growth of small businesses by expanding capital formation techniques, removing undesirable tax traps, and reforming the tax treatment of fringe benefits.

The Chamber recommends updating several provisions that would provide S corporations additional access to capital and allow for greater flexibility. Those recommendations are:

Increase the 100 shareholder limitation to 150. Increasing the number of permissible shareholders from 100 to 150 would make S corporation status available to more closely-held businesses and enable them to raise more capital.

Permit nonresident aliens to be shareholders. Allowing nonresident aliens to be shareholders in S corporations would enable these businesses to expand into international markets. In order to

ensure the collection of taxes, these shareholders would be subject to U.S. withholding tax on their portion of S corporation income.

Allow S corporations to issue preferred stock. Under current law, S corporations may not issue more than one class of stock. Allowing S corporations to issue “plain vanilla” nonconvertible preferred stock, in addition to common stock, would increase their ability to obtain capital from those investors who demand preferential treatment. Furthermore, family succession would be enhanced since older shareholders could relinquish control of the business while maintaining equity interests. Any dividends paid on such stock would be treated as interest for federal tax purposes.

Decrease the holding period of assets subject to the built-in gains (BIG) tax from 10 years to seven years. Currently, businesses converting to S corporation status must hold on to any appreciated assets for 10 years following the conversion or be subjected to a entity level tax on the built-in gain at the highest corporate tax rate (35 percent in addition to individual federal, state, and local taxes). Reducing the holding period of assets subject to the built-in gain tax from 10 years to seven years would allow S corporations to access their own capital sooner, stimulating growth in their business as well as the broader economy.

The Chamber also recommends removing various tax traps, which the unwary become subject to. The Chamber recommends:

Repeal excessive passive investment income as a termination event and exclude trade or business income from the definition of passive investment income. Currently, a corporation’s subchapter S status is terminated if at the close of three consecutive taxable years, the corporation has subchapter C earnings and profits and more than 25 percent of its gross receipts are deemed to be passive investment income. This provision would repeal such termination and would provide that all items of income connected to an S corporation’s trade or business would not be considered passive income. The threshold for taxing excess passive income also would be increased from 25 to 60 percent of the gross receipts of the corporation.

Expand eligible S corporation shareholders to include individual retirement accounts (IRAs). Under current law, an IRA cannot be an S corporation shareholder, except where the S corporation is in the banking industry. Allowing IRAs to hold stock in S corporations would prevent inadvertent S corporation termination where a retiring employee, not knowing the complex S corporation rules, rolls his S corporation shares into an IRA. Consistent with the current bank S corporation rules, there would be a specific prohibited transaction exception for sales to the individual within 120 days of election. The pass through income would be unrelated business income to the IRA shareholder, subject to the unrelated business income tax (UBIT).

The Chamber also advocates reforming the treatment of various fringe benefits to S corporation shareholders. Specifically, the Chamber recommends:

Place S corporation shareholders in the same position as C corporation shareholders/employees with respect to fringe benefits. Under current law, shareholders owning more than 2 percent of an S corporation are not eligible to exclude from income the value of otherwise excludible fringe benefits. The Chamber recommends reforming the S corporation provisions to treat S corporation shareholders the same as those in C corporations.

CONCLUSION

The Chamber believes that the reforms suggested above would provide S corporations greater access to capital, ease the current burdensome rules, and place these businesses on a level playing field with domestic and foreign competitors.

Chairwoman Bean, Ranking Member Buchanan, and members of the Subcommittee, the Chamber applauds your leadership in conducting this hearing and thanks you for the opportunity to comment on this issue.