Testimony of

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U.S. House of Representatives
Committee on Small Business
Subcommittee on Regulatory Reform and Oversight

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Topic: S Corporations – Their History and Challenges

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit ***http://www.sba.gov/advo****, or call (202) 205-6533.*

Good morning Chairman Akin and Members of the Subcommittee, I thank you for this opportunity to appear before you today. My name is Thomas M. Sullivan, and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). The Committee invited me here today to discuss the importance of S-corporations in the U.S. economy, recent legislative proposals, and the Internal Revenue Service's (IRS) audit study of S-corporations.

Congress established the Office of Advocacy (Advocacy) to represent the views of small business before Congress and Federal agencies. The Office of Advocacy is an independent office within the SBA, and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. This statement was not circulated to the Office of Management and Budget (OMB) for comment. Advocacy takes its direction from small businesses, therefore this statement is based on the interests and concerns communicated to us by small business groups.

Small Business and the U.S. Economy

Small businesses are a driving force in the U.S. economy. They comprise 99.7 percent of all employer firms in the U.S., employ half of all the private sector workers, and have generated 60 to 80 percent of the net new jobs annually over the last decade.[1] Small firms pay 45 percent of the total U.S. private payroll, and create about half of the non-farm private gross domestic product.[2] Small businesses also tend to innovate at a higher rate than medium or large businesses,[3] producing 13 to 14 times more patents per employee.[4] Furthermore, small firm patents are more likely to be driven by leading-edge technology than large firm patents.[5] Finally, during economic downturns, small businesses fare better than their larger counterparts. Increases in small business employment and self-employment often help steer the economy out of recessions.

Just as small businesses are the cornerstone of the U.S. economy, S-corporations are the cornerstone of the small business economy. According to IRS Statistics of Income for tax year 2002 there were approximately 3.1 million S-corporation returns filed, making up 59.6 percent of all corporate returns. S-corporations generated $3.9 trillion in annual revenue. According to the Bureau of Census 1997 statistics, S-corporations are the second largest employer, employing approximately 21 million Americans.[6]

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[1] Frequently Asked Questions, Office of Advocacy, U.S. Small Business Administration, 2006, available at http://www.sba.gov/advo/stats/sbfaq.pdf.

[2] Joel Popkin and Company, *Small Business Share of NAICS Industries*, study funded by the Office of Advocacy, U.S. Small Business Administration (2002), available at http://www.sba.gov/advo/research/rs218tot.pdf.

[3] U.S. Small Business Administration, *The State of Small Business: A Report to the President* (2005).

[4] CHI Research, Inc., *Small Serial Innovators: The Small Firm Contribution to Technical Change*, study funded by the Office of Advocacy, U.S. Small Business Administration (2003), available at www.sba.gov/advo/research/rs225tot.pdf.

[5] *Id*.

[6] Table 7. Statistics for All U.S. Firms by Major Industry Group and Legal Form of Organization: 1997. This is the most recent data available. Data for 2002 is expected to be released before the end of the year.

Proposed Legislation – H.R. 4421

S-corporations were created in 1958. They were developed to enhance entrepreneurial activity and to eliminate the negative effects of double taxation experienced by taxable corporations (C-corporations).[7] C-corporations are subject to double taxation because the corporation itself is liable for income tax on its earnings, then when dividends are distributed to the shareholders the shareholders must pay income tax on those dividends. To receive favorable tax treatment, entities electing S status must adhere to many restrictions, including:

- the number of shareholders,
- type of shareholder,
- class of stock and
- domesticity requirements for S-corporation elections.

In the half century since the creation of S-corporations, the U.S economy and the world's economies have changed. With the advent of technology, globalization of the economy has become more of a reality. Policymakers considering changes to tax policy must take a broader view that includes tax policies around the world. To ensure America's entrepreneurs remain competitive, in a global marketplace, we must adopt tax policies that remove barriers to their success.

S-corporations are a large segment of the U.S. economy. To ensure their continued success H.R. 4421, the "*S Corporation Reform Act of 2005*," was introduced by Congressmen Clay Shaw and Jim Ramstad. The legislation is intended to reform the provisions that control S-corporations so that S-corporations can reach their full potential. H.R. 4421 contains provisions that are advocated and supported by the American Institute of Certified Public Accountants and others.

Take the Sting out of the Sting Tax

Current law penalizes S-corporations if they earn too much passive investment income (this rule is commonly known as the "sting tax").[8] Specifically, if an S-corporation that previously was a C-corporation has undistributed dividends, and earns 25 percent of its gross receipts as passive investment income, then two things will happen. First, the S-corporation is taxed on its income at the highest corporate rate. Second, if the S-corporation earns too much passive investment income for three consecutive years, then the S election is terminated all together. The result is that the S-corporation becomes subject to double taxation. Double taxation is the penalty for earning too much of the wrong type of income (i.e. passive investment income) and/or earning that income too often, thus eliminating the purpose for electing S status.

[7] Other legal forms of taxpayers that are subject to a single layer of tax, such as partnerships and limited liability companies, are commonly known as passthrough entities. Generally, this means that the entity itself is not taxed on its earnings, but the owners of the entity must report the earnings on their personal income tax return.

[8] Internal Revenue Code section 1362(d)(3)(C) defines passive investment income as receipts derived from rents, royalties, dividends, interest, annuities and gains from the sale of stock or securities.

The sting tax is out of step with today's tax provisions. Tax policy has been moving away from double taxation and toward a system of single taxation. C-corporations which are subject to double taxation have not been growing as rapidly as entities that are not subject to a single layer of tax (theses entities are commonly known as passthrough entities).[9] The sting tax was created to mirror rules that applied to C-corporations that were personal holding companies (PHC). PHCs are no longer prohibited from generating passive investment income from gain on the sale of stock or securities. Additionally, PHCs are permitted to earn up to 60 percent of their gross revenue as passive investment income. The sting tax does not affect other passthrough entities, such as partnerships and limited liability companies. This puts S-corporations at a competitive disadvantage with other passthrough entities. S-corporations that were previously C-corporations should not suffer harsher treatment simply because they earn the wrong type of income. H.R. 4421 seeks to remedy this inequity by reforming the sting tax.

In addition to the disparate treatment S-corporations receive as compared to PHCs, the sting tax has other negative effects. Small and family-owned businesses are often not aware of the sting tax. Thus, the sting tax punishes the unwary. Small business owners have many laws and regulations to be aware of as they conduct their business. Our tax code should not set up traps for the unwary.

All These Restrictions – How Can We Grow?

Under current law, S-corporations can have only one class of stock, debt can not be converted to stock, and shareholders can neither be a nonresident alien nor an individual retirements account (IRA). In today's business environment, these restrictions build unique barriers for planning for the future of the family business, and restrict the S-corporation's access to capital. H.R. 4421 would remove these restrictions.

It is common to plan for the next generation of leadership of a family business, by issuing preferred shares to the generation that is leaving the business as a means to provide for their retirement and their orderly withdrawal from the enterprise. However, because S-corporations may not have more than one class of stock, this practice is prohibited. Thus, family owned businesses must incur additional expense to ensure that the retiring generation is provided for. Prohibiting nonresident aliens and IRAs from being shareholders adds to the complicated planning. H.R. 4421 would allow S-corporations to issue qualified preferred stock which will enhance succession planning for many small family-owned businesses.

America's families are changing. It is not uncommon for today's American family to include nonresident aliens. When an S-corporation's related shareholders include a nonresident alien, it faces additional planning to ensure that the nonresident alien is provided for and that the S election is not violated. Both chambers of Congress are working diligently to take the bite out of estate planning; the reforms in H.R. 4421 enhance those efforts.

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[9] IRS Statistics of Income; S Corporation Returns, 2002 (from 1986 to 2002 C-corporation returns have declined on average 1.3 percent annually).

H.R. 4421 recognizes the need to enhance the growth potential for S-corporations by removing outdated restrictions. Provisions of H.R. 4421 would remove the limit on one class of stock, the prohibition against debt convertible to stock, and would permit nonresident aliens and IRAs to be shareholders of an S-corporation. Together these provisions decrease the complexity of planning for the future of the small family business and increase the growth potential of S-corporations by removing barriers to access to capital.

Everyone Makes Mistakes

To have a valid S election the electing corporation and its shareholders must take the necessary steps to perfect or complete the election within a specified period of time. If the election is not timely completed or is defective, the Treasury Secretary may excuse the imperfection if the electing corporation and its shareholders take the necessary steps to ensure the S election requirements are met. Obtaining an excuse for an imperfect election is not guaranteed. Additionally, the time period that is covered by the excuse is not certain. H.R. 4421 recognizes that not every taxpayer is savvy, nor represented by sophisticated tax counsel. The bill provides additional protection for invalid elections or terminations of an S election. Specifically, H.R. 4421 permits the Treasury Secretary to extend the excuse for an invalid election or inadvertent termination of an election for a period of time that covers tax years for which a refund or credit has not expired.

The importance of this protection is amplified when there is an attempted acquisition of an S-corporation. Acquiring a business requires a high degree of due diligence. One area that must be investigated when attempting to acquire an S-corporation is whether the S election has always been valid. Without this assurance, an acquirer takes the risk that the rules against passive investment income (and other rules) may increase the cost of their investment. Having the assurance that an inadvertent violation of the S rules is not fatal to the S election will limit the risk a potential acquirer must consider when purchasing an S-corporation.

IRS National Research Program (NRP)

In February 2006, the IRS announced the results of its tax year 2001 NRP study of high wealth individuals and small businesses that file Schedule C. The results of the NRP indicate that there is a net tax gap of approximately $290 billion.[10] The tax gap is defined as the difference between what taxpayers owe and pay on time and what actually gets paid on a timely basis. The net tax gap is the remaining gap after IRS enforcement actions and other late payments are made. The IRS reported the study results and attributed the majority of the tax gap to small businesses which file Schedule C, despite not having updated data on other types of taxpayers such as partnerships and C-corporations.

On July 25, 2005, the IRS announced its plans to conduct an NRP compliance audit study of 5,000 S-corporation returns from tax years 2003 and 2004. Commissioner Mark Everson justified this new study based on the fact that the number of S-corporations

[10] *IRS Updates Tax Gap Estimates*, 2006 TNT 31-6 (February 15, 2006).

has grown between 1985 and 2002 from approximately 724,000 corporations to about 3.1 million corporations. S-corporations only account for approximately 19 percent of corporate revenue.[11] Along with auditing the S-corporation returns, the IRS plans to audit all returns of S-corporation shareholders with 20 percent or more ownership interest in the corporation under audit. The small business community is concerned they are the only sector that is being subjected to an in-depth audit study. The Office of Advocacy shares small business' concerns.

America's small businesses succeed because of their ingenuity and innovation. Research sponsored by Advocacy continues to show that the cost of tax compliance is 67 percent higher in small firms than in large firms.[12] Facing an audit increases the costs of tax compliance by requiring business owners to incur the expense of representation and it takes time away from their business to answer IRS inquiries. Small businesses take their responsibility to pay their fair share of taxes seriously. No one wants to defend those that deliberately cheat the system. However, IRS' approach may punish those that voluntarily comply with the law, based on the failures of those that do not.

In summary, small businesses have a long history of contributing greatly to the American economy. S-corporations play a critical role in keeping the economy strong. To ensure their continued success, government has to be wary of taking steps that may stifle the entrepreneurial growth of S-corporations. Legislation introduced to reform S-corporation provisions should be based on tax policy that enhances entrepreneurial competitiveness H.R. 4421 accomplishes this. As the IRS strengthens tax compliance efforts, attention should be given to why taxpayers become noncompliant so that recommendations are tailored to meet those challenges.

Thank you for allowing me to present these views. I am happy to answer any questions.

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[11] Id. note 9.
[12] *The Impact of Regulatory Costs on Small Firms*, Crain, W. M., September 2005, U.S. Small Business Administration, Office of Advocacy (SBHQ-03-M-0522), available at http://www.sba.gov/advo/research/rs264tot.pdf (tax compliance cost large firms $780 per employee).