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113TH CONGRESS
2d Session
HOUSE OF REPRESENTATIVES
REPORT
113–429

PERMANENT S CORPORATION BUILT-IN GAINS RECOGNITION PERIOD ACT OF 2014

MAY 2, 2014.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. CAMP, from the Committee on Ways and Means, submitted the following

R E P O R T

together with

DISSENTING VIEWS

[To accompany H.R. 4453]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 4453) to amend the Internal Revenue Code of 1986 to make permanent the reduced recognition period for built-in gains of S corporations, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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39–006

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Permanent S Corporation Built-in Gains Recognition Period Act of 2014".

SEC. 2. REDUCED RECOGNITION PERIOD FOR BUILT-IN GAINS OF S CORPORATIONS MADE PERMANENT.

(a) IN GENERAL.—Paragraph (7) of section 1374(d) of the Internal Revenue Code of 1986 is amended to read as follows:

"(7) RECOGNITION PERIOD.—

"(A) IN GENERAL.—The term 'recognition period' means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.

"(B) INSTALLMENT SALES.—If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2013.

I. SUMMARY AND BACKGROUND

A. PURPOSE AND SUMMARY

Identical to a provision contained in the discussion draft of the "Tax Reform Act of 2014" released on February 26, 2014, the bill, H.R. 4453, reported by the Committee on Ways and Means, provides a permanent five-year recognition period for built-in gains of an S corporation. A temporary provision, which expired for taxable years beginning after December 31, 2013, also provided a five-year recognition period for built-in gains of an S corporation. With the expiration of that temporary provision, however, the recognition period is currently ten years for taxable years beginning after December 31, 2013.

B. BACKGROUND AND NEED FOR LEGISLATION

While the Committee continues actively to pursue comprehensive tax reform as a critical means of promoting economic growth and job creation, the Committee also believes that it is important to provide small businesses permanent, immediate tax relief to help encourage economic growth and job creation. By providing small businesses organized as S corporations with a permanent five-year period for the recognition of certain built-in gains, H.R. 4453 will provide much needed certainty for S corporations that have contended with temporary changes to the recognition period for years. Additionally, H.R. 4453 will eliminate a significant deterrent that often discourages C corporations from electing to be S corporations,

and will provide additional flexibility for S corporations to access capital by selling unproductive assets to finance expansion of their businesses and create jobs.

C. Legislative History

BACKGROUND

H.R. 4453 was introduced on April 10, 2014, and was referred to the Committee on Ways and Means.

COMMITTEE ACTION

The Committee on Ways and Means marked up H.R. 4453, the Permanent S Corporation Built-in Gains Recognition Period Act of 2014, on April 29, 2014, and ordered the bill, as amended, favorably reported (with a quorum being present).

COMMITTEE HEARINGS

The need for a permanent five-year recognition period for built-in gains of S corporations was discussed at no fewer than four hearings during the 112th and 113th Congresses:

- Full Committee hearing on Fundamental Tax Reform (January 20, 2011);
- Full Committee hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform (March 7, 2012);
- Select Revenue Measures Subcommittee hearing on the Small Business and Pass-Through Entity Tax Reform Discussion Draft (May 15, 2013); and
- Full Committee hearing on the Benefits of Permanent Tax Policy for America's Job Creators (April 8, 2014).

II. EXPLANATION OF THE BILL

A. Reduced Recognition Period for Built-In Gains of S Corporations Made Permanent (sec. 1374 of the Code)

PRESENT LAW

In general

S corporations

A small business corporation[1] may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[2]

A corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[3] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, (*i.e.,* the 10-year period beginning with the first day of the first taxable year

[1] This term is defined in section 1361(b).
[2] Sec. 1366.
[3] Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

for which the S election is in effect).[4] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no built-in gain tax is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year.[5] Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method[6] during or after the recognition period, that income is subject to the built-in gain tax.[7]

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation.[8] In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[9]

The amount of the built-in gains tax is treated as a loss by each of the S corporation shareholders in computing its own income tax.[10]

For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year.[11] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year that the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the fifth year in the corporation's recognition period preceded such taxable year.[12] Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the S corporation election was in effect for five years preceding the taxable year beginning in 2011.

For taxable years beginning in 2012 and 2013, the term "recognition period" in section 1374, for purposes of determining the net recognized built-in gain, is applied by substituting a five-year period[13] for the otherwise applicable 10-year period. Thus, for such taxable years, the recognition period is the five-year period begin-

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[4] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374–1(d).
[5] Sec. 1374(d)(2).
[6] Sec. 453.
[7] Treas. Reg. sec. 1.1374–4(h).
[8] Sec. 1374(d)(8).
[9] Sec. 1374(d)(8)(B).
[10] Sec. 1366(f)(2). Shareholders continue to take into account all items of gain and loss under section 1366.
[11] Sec. 1374(d)(7)(B).
[12] Sec. 1374(d)(7)(C).
[13] The five-year period refers to five calendar years from the first day of the first taxable year for which the corporation was an S corporation.

ning with the first day of the first taxable year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation apply). If an S corporation with assets subject to section 1374 disposes of such assets in a taxable year beginning in 2012 or 2013 and the disposition occurs more than five years after the first day of the relevant recognition period, gain or loss on the disposition will not be taken into account in determining the net recognized built-in gain.

If an S corporation subject to section 1374 sells a built-in gain asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received will be governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made.

Application to real estate investment trusts and regulated investment corporations

Under Treasury regulations, a regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation not taxed as a REIT or RIC (or that acquired assets from such a C corporation) generally is subject to the built-in gain tax rules as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment, requiring recognition of all C corporation built-in gain and loss at the time of the conversion or asset acquisition.[14] Deemed sale treatment is not permitted if its application would result in the recognition of a net loss.[15] For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.[16]

REASONS FOR CHANGE

The Committee believes that a five-year recognition period for built-in gains adequately protects the corporate tax base while allowing greater flexibility for S corporations to replace and reposition assets, allowing S corporations to access capital to expand business operations and create jobs. The Committee also believes that making the five-year recognition period permanent will provide needed certainty and remove a significant deterrent that often discourages C corporations from electing to be S corporations.

EXPLANATION OF PROVISION

The provision makes permanent the five-year recognition period for built-in gains of S corporations. Under current Treasury regulations, this five-year recognition period also will apply to real estate investment trusts and regulated investment companies that do not elect "deemed sale" treatment.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2013.

[14] Treas. Reg. secs. 1.337(d)–7(a) and 1.337(d)–7(b).
[15] Treas. Reg. sec. 1.337(d)–7(c)(1).
[16] Treas. Reg. sec. 1.337(d)–7(c)(1).

III. VOTES OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the vote of the Committee on Ways and Means in its consideration of H.R. 4453, the Permanent S Corporation Built-in Gains Recognition Period Act of 2014.

The bill, H.R. 4453, was ordered favorably reported as amended by a roll call vote of 21 yeas to 13 nays (with a quorum being present). The vote was as follows:

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Camp	✓			Mr. Levin		✓	
Mr. Johnson	✓			Mr. Rangel		✓	
Mr. Brady	✓			Mr. McDermott		✓	
Mr. Ryan	✓			Mr. Lewis		✓	
Mr. Nunes	✓			Mr. Neal			
Mr. Tiberi	✓			Mr. Becerra		✓	
Mr. Reichert	✓			Mr. Doggett		✓	
Mr. Boustany	✓			Mr. Thompson		✓	
Mr. Roskam	✓			Mr. Larson		✓	
Mr. Gerlach				Mr. Blumenauer		✓	
Mr. Price	✓			Mr. Kind			
Mr. Buchanan	✓			Mr. Pascrell		✓	
Mr. Smith	✓			Mr. Crowley		✓	
Mr. Schock	✓			Ms. Schwartz			
Ms. Jenkins	✓			Mr. Davis		✓	
Mr. Paulsen	✓			Ms. Sanchez		✓	
Mr. Marchant	✓						
Ms. Black	✓						
Mr. Reed	✓						
Mr. Young	✓						
Mr. Kelly	✓						
Mr. Griffin							
Mr. Renacci	✓						

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATE OF BUDGETARY EFFECTS

In compliance with clause 3(d) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effects on the budget of the bill, H.R. 4453, as reported.

The bill, as reported, is estimated to have the following effects on Federal budget receipts for fiscal years 2014–2024:

By fiscal years in billions of dollars—												
2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014–19	2014–24
– – –	−0.2	−0.2	−0.3	−0.2	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−1.0	−1.5

NOTE: Details do not add to totals due to rounding.

B. STATEMENT REGARDING NEW BUDGET AUTHORITY AND TAX EXPENDITURES BUDGET AUTHORITY

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the bill involves no new or increased budget authority. The Committee further states that whether or not the bill increases a tax expenditure is ambiguous because the existence of subchapter S does not create any tax expenditures, but distributions from a C corporation generally give rise to tax liability.

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, requiring a cost estimate prepared by the CBO, the following statement by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, May 1, 2014.

Hon. DAVE CAMP,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 4453, the Permanent S Corporation Built-in Gains Recognition Period Act of 2014.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Logan Timmerhoff.

Sincerely,

DOUGLAS W. ELMENDORF.

Enclosure.

H.R. 4453—Permanent S Corporation Built-in Gains Recognition Period Act of 2014

H.R. 4453 would amend the Internal Revenue Code to make permanent a five-year recognition period for built-in gains of S corporations, retroactive to January 1, 2014. Under current law, a corporation that meets certain requirements may elect to be taxed as an S corporation, which generally pays no corporate-level tax, unlike a C corporation. For corporations that convert from C corpora-

tions to S corporations, or S corporations that receive assets under certain conditions from C corporations, there is a corporate-level tax on certain built-in gains of certain assets, with a 10-year recognition period under current law. This legislation makes permanent the five-year recognition period for S corporation built-in gains that was generally in effect for taxable years from 2011 through 2013. The legislation also applies to regulated investment companies and real estate investment trusts.

The staff of the Joint Committee on Taxation (JCT) estimates that enacting H.R. 4453 would reduce revenues, thus increasing federal deficits, by $1.5 billion over the 2014–2024 period.

The Statutory Pay-As-You-Go Act of 2010 establishes budget-reporting and enforcement procedures for legislation affecting direct spending and revenues. Enacting H.R. 4453 would result in revenue losses in each year beginning in 2015. The estimated increases in the deficit are shown in the following table.

JCT has determined that the bill contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act.

The CBO staff contact for this estimate is Logan Timmerhoff. The estimate was approved by David Weiner, Assistant Director for Tax Analysis.

CBO ESTIMATE OF PAY-AS-YOU-GO EFFECTS FOR H.R. 4453, AS ORDERED REPORTED BY THE HOUSE COMMITTEE ON WAYS AND MEANS ON APRIL 29, 2014

	By fiscal year, in millions of dollars—												
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2014–2019	2014–2024
	NET INCREASE IN THE DEFICIT												
Statutory Pay-As-You-Go Effects ...	0	155	221	287	225	148	104	84	82	86	93	1,036	1,485

Note: Components may not sum to totals because of rounding.
Source: Staff of the Joint Committee on Taxation.

D. Macroeconomic Impact Analysis

In compliance with clause 3(h)(2) of rule XIII of the Rules of the House of Representatives, the following statement is made by the Joint Committee on Taxation with respect to the provisions of the bill amending the Internal Revenue Code of 1986: the effects of the bill on economic activity are so small as to be incalculable within the context of a model of the aggregate economy.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. Committee Oversight Findings and Recommendations

With respect to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was as a result of the Committee's review of the provisions of H.R. 4453 that the Committee concluded that it is appropriate to report the bill, as amended, favorably to the House of Representatives with the recommendation that the bill do pass.

B. Statement of General Performance Goals and Objectives

With respect to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee advises that the bill contains no measure that authorizes funding, so no statement of general performance goals and objectives for which any measure authorizes funding is required.

C. Information Relating to Unfunded Mandates

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. No. 104–4).

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

D. Applicability of House Rule XXI 5(b)

Rule XXI 5(b) of the Rules of the House of Representatives provides, in part, that "A bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase may not be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members voting, a quorum being present." The Committee has carefully reviewed the bill, and states that the bill does not involve any Federal income tax rate increases within the meaning of the rule.

E. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Treasury Department) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses.

Pursuant to clause 3(h)(1) of rule XIII of the Rules of the House of Representatives, the staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have "widespread applicability" to individuals or small businesses, within the meaning of the rule.

F. Congressional Earmarks, Limited Tax Benefits, and Limited Tariff Benefits

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

G. DUPLICATION OF FEDERAL PROGRAMS

In compliance with Sec. 3(j)(2) of H. Res. 5 (113th Congress), the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program, (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139, or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Public Law 95–220, as amended by Public Law 98–169).

H. DISCLOSURE OF DIRECTED RULE MAKINGS

In compliance with Sec. 3(k) of H. Res. 5 (113th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires no directed rule makings within the meaning of such section.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTION 1374 OF THE INTERNAL REVENUE CODE OF 1986

SEC. 1374. TAX IMPOSED ON CERTAIN BUILT-IN GAINS.

(a) * * *

* * * * * * *

(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) * * *

* * * * * * *

[(7) RECOGNITION PERIOD.—

[(A) IN GENERAL.—The term "recognition period" means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation.

[(B) SPECIAL RULES FOR 2009, 2010, AND 2011.—No tax shall be imposed on the net recognized built-in gain of an S corporation—

[(i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or

[(ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.

The preceding sentence shall be applied separately with respect to any asset to which paragraph (8) applies.

[(C) SPECIAL RULE FOR 2012 AND 2013.—For purposes of determining the net recognized built-in gain for taxable years beginning in 2012 or 2013, subparagraphs (A) and (D) shall be applied by substituting "5-year" for "10-year".

[(D) SPECIAL RULE FOR DISTRIBUTIONS TO SHAREHOLDERS.—For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e)—

[(i) subparagraph (A) shall be applied without regard to the phrase "10-year", and

[(ii) subparagraph (B) shall not apply.

[(E) INSTALLMENT SALES.—If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.]

(7) RECOGNITION PERIOD.—

(A) IN GENERAL.—The term "recognition period" means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase "5-year".

(B) INSTALLMENT SALES.—If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

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VII. DISSENTING VIEWS

These bills would add a combined $310 billion to the deficit. Even though these bills were introduced individually with some bipartisan support, the opposition to these bills was based on the position that these tax provisions should not be made permanent by adding to the deficit without any revenue offset.

To put the combined cost ($310 billion) into context, this total represents more than one-half of the entire federal deficit this year—the lowest it has been since President Obama took office. It represents nearly two-thirds of all non-defense domestic discretionary spending in 2014. It is more than three times what we spend annually on education, job training, and social services. It is five times more than we spend on veterans. And, it is five times more than we spend on medical research and public health.

We also opposed the manner in which Republicans were proceeding—selecting six to make permanent without any offset from the approximately 60 tax provisions that expired last year. This approach was both fiscally irresponsible and fundamentally hypocritical.

We found it hypocritical that, four months ago, Republicans let emergency unemployment insurance expire for more than 1.3 million Americans by arguing that an adequate offset had yet to be proposed. In early April, the Senate came to a bipartisan agreement on an offset after months of painstaking negotiations. Yet House Republicans still refuse to act.

Further, we found it also hypocritical that the Republicans were in favor of passing these six tax bills at a cost of $310 billion without an offset at the same time that they were requiring an offset for a provision stripped from another bill under consideration at the markup that helped foster children at a cost of $12 million.

The consideration of these six tax bills should have been part of the consideration of all the expired tax provisions commonly referred to as "tax extenders." The Republicans did not take up other tax extenders that also are important to Democratic Committee Members. Left to an uncertain fate are provisions like the Work Opportunity Tax Credit, the New Markets Tax Credit, and the renewable energy tax credits, as well as the long-term status of the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit.

Sincerely,

SANDER M. LEVIN
Ranking Member.

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