

## F I N A L   R E P O R T

### SUBCHAPTER S CORPORATIONS STUDY COMMITTEE

January 1990

#### AUTHORIZATION AND APPOINTMENT

The Subchapter S Corporations Study Committee was established by the Legislative Council to "study the taxation of resident shareholders of subchapter S corporations which engage in interstate and intrastate business and make recommendations on necessary changes, if needed. Final meeting date no later than November 1, 1989."

Members serving on the Study Committee were:

Senator Emil Husak, Co-chairperson  
Representative Kay Chapman, Co-chairperson  
Senator Jack Hester  
Senator Calvin Hultman  
Senator Larry Murphy  
Senator Elaine Szymoniak  
Representative Minnette Doderer  
Representative Steven Hansen  
Representative Robert Renken  
Representative Bill Trent

#### COMMITTEE PROCEEDINGS

The Study Committee was authorized two meeting days. These were held at the State Capitol Building in Des Moines on September 21, 1989, and October 24, 1989. At the September 21 meeting the Study Committee heard a presentation by Mr. Carl Castelda, Deputy Director of the Department of Revenue and Finance, which provided information to the members explaining the current statutes and congressional history relating to subchapter S corporations, Iowa's tax treatment of subchapter S corporations, impact on those corporations as a result of the federal Tax Reform Act of 1986, other states' policies relating to those corporations, and a discussion of two alternative ways of treating subchapter S corporate income for state tax purposes and the issues that need to be resolved for each. Subchapter S corporations are corporations that have elected for federal tax purposes to have the corporation's income taxed directly to the shareholders and the corporations as a result are not subject to the federal corporate income tax. Iowa treats corporations that have made this election for federal tax purposes and their shareholders the same. The two

alternatives that the Department analyzed were: 1.) to allow the proration of state tax in the ratio of Iowa source income, including only an apportioned share of the subchapter S corporation income, to total income; and 2.) to allow a subchapter S corporation to elect not to be treated as a subchapter S corporation for state tax purposes.

Also making presentations were Mr. Paul Hayes of McGladrey, Hendrickson & Pullen and Mr. Rusty Goode of Ernst & Young. Mr. Hayes clarified that the shareholders of a subchapter S corporation are taxed on the corporation's income whether they receive it or not. Mr. Goode discussed the reasons for the increase in the number of corporations electing subchapter S status as a result of the federal Tax Reform Act of 1986. Mr. Goode also described the tax consequences to a hypothetical corporation under different circumstances.

The Study Committee, after much discussion, directed the Legislative Service Bureau to draft as a bill the Department of Revenue and Finance's alternative 2 that would permit a subchapter S corporation to elect not to be treated as a subchapter S corporation for state tax purposes. The Department was asked to suggest solutions to the issues arising from permitting this alternative and provide them to the members and the Legislative Service Bureau for inclusion in the draft. The Study Committee requested that the model subchapter S corporation law that the Iowa Bar Association was studying also be drafted. The bills were drafted for discussion at the next meeting of the Study Committee.

At the second and last meeting of the Study Committee, Mr. Castelda discussed the analysis the Department of Revenue and Finance conducted on the corporations that were regular corporations in 1986 and filed as subchapter S corporations in 1987. The analysis looked at the 411 corporations that were identified as having apportioned income with and without the state when previously filing regular corporate returns. The analysis of the 411 corporations further focused on those resident corporations that had apportionable income and a breakdown was done on the class of business, the total income of the businesses, and the tax benefits that would be received by the corporation.

Mr. Richard Phillips of the Iowa Taxpayers Association was available to make comments and answer questions from the Committee members. Mr. Phillips stated the Department of Revenue and Finance's alternative 2 was the fairer because it would allow the shareholders of a subchapter S corporation to be taxed as a regular corporation for state tax purposes, thus resulting in the corporation's income being taxed like the income of other corporations, i.e. subject to apportionment.

Mr. Jim Nepple of the Iowa Bar Association made a few comments relating to the ABA Model Act for subchapter S corporations. He

emphasized that the Iowa Bar Association is studying the Model Act but does not have an opinion on its desirability for Iowa. He also commented that the alternative 2 election can be done but felt the administration involved in such election could be complicated.

The staff of the Legislative Service Bureau explained the bill proposals it had completed for the Committee.

#### RECOMMENDATIONS

The Study Committee decided that it was not ready to make a recommendation relating to the tax status of subchapter S corporations, but it directed the Legislative Service Bureau to provide the drafts and other information obtained for and during the meetings to the Chairpersons of the Senate and House Standing Committees on Ways and Means and to any members of those Committees who would like them.

cw,2119ic  
mg/dg/20