

SECTION 1. SHORT TITLE. This Act may be cited as "Small Business Tax Modernization Act of 2004".

SEC. 2. UNIFIED PASS-THRU ENTITY REGIME. (a) Termination of S Corporation Status.-- (1) No new s corporation elections.--Subsection (a) of section 1362 of the Internal Revenue Code of 1986 is amended by adding at the end the following new paragraph: "(3) Termination of authority to make election.--No election may be made under paragraph (1) for any taxable year beginning after December 31, 2004." (2) Termination of status.--Subsection (d) of section 1362 of such Code (relating to termination) is amended by adding at the end the following new paragraph: "(4) Treatment as partnership after 2014.--An election under subsection (a)-- (A) shall not be effective for any taxable year beginning after December 31, 2014, and (B) shall be treated as an election under section 7701(a)(2)(B) for taxable years beginning after such date." (3) Effective date.--The amendments made by this subsection shall apply to taxable years beginning after December 31, 2004. (b) Election by Certain Corporations to Be Taxed as Partnership.-- (1) In general.--Paragraph (2) of section 7701(a) of such Code (defining partnership and partner) is amended to read as follows: "(2) Partnership and partner.-- (A) In general.--The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization. (B) Election by corporation to be taxed as partnership.-- (i) In general.--An eligible corporation may elect to be treated as a partnership for purposes of this title. (ii) Tax treatment.--Except as provided in section 1379A-- (I) no gain or loss shall be recognized to the corporation or the shareholders by reason of an election under clause (i), and (II) except in the case of an election made by a S corporation after the end of the recognition period (as defined in section 1374(d)(7) without regard to subparagraph (B) thereof), section 1374 shall apply to the entity after such election. (iii) Eligible corporation.--For purposes of clause (i), the term 'eligible corporation' means an entity-- (I) which, without regard to this subparagraph, is a domestic corporation no stock of which is readily tradable on an established securities market or otherwise, and (II) which is not an ineligible corporation (as defined by section 1361(b)(2)). (iv) Election and termination.--For purposes of this subparagraph, rules similar to the rules of section 1362 (other than subsections (a)(3), (d)(3) and (4), and (e) thereof) shall apply. (v) Distributions, etc.--Each partner shall include in gross income as a dividend, any amount that would have been so includible had the entity been an S corporation during the period the entity was treated as a partnership. Notwithstanding the preceding sentence, the provisions of subchapter K of chapter 1 shall apply to determine the basis of any property distributed and the basis of any interest in the partnership. (vi) Cross reference.--For tax treatment of S corporation electing unified pass-thru regime, see section 1379A." (2) Tax treatment of s corporation electing unified pass- thru regime.-- (A) In general.--Part IV of subchapter S of chapter 1 of such Code is amended by inserting after section 1379 the following new section: "SEC. 1379A. TAX TREATMENT OF S CORPORATION ELECTING UNIFIED PASS-THRU REGIME. "In the case of an election under section 7701(a)(2)(B) by an S corporation before January 1, 2015, with respect to the corporation-- (1) the shareholders shall be treated as if the assets were distributed, on the date of such election, to the shareholders in exchange for their stock, (2) any gain or loss recognized to the shareholders by reason of paragraph (1) shall be taken into account by the shareholders ratably over the taxable year in which the distribution is deemed to be made under paragraph (1) and the succeeding 4 taxable years, and (3) proper adjustments to the basis of interests in the entity shall be made." (B) Clerical amendment.--The table of sections for part IV of subchapter S of chapter 1 of such Code is amended by inserting after the item relating to section 1379 the following new item: "Sec. 1379A. Tax treatment of S corporation electing unified pass-thru regime." (3) Modification to treatment of section 1374 tax for earnings and profits purposes.-- Paragraph (2) of section 1366(f) of such Code is amended to read as follows: "(2) Treatment of tax

imposed on built-in gains.-- `` (A) In general.--The amount of the items of the net recognized built-in gain taken into account under section 1374(b)(1) (reduced by any deduction allowed under section 1374(b)(2)) shall not be taken into account under this section. `` (B) Earnings and profits.--The accumulated earnings and profits of the corporation shall be increased at the beginning of the taxable year by the amount not taken into account under this section by reason of subparagraph (A) (determined without regard to section 1374(b)(2)) reduced by the tax imposed by section 1374 (net of credits allowed).". (4) Effect of election on recognition period for purposes of tax imposed on built-in gains.--Paragraph (7) of section 1374(d) of such Code is amended to read as follows: `` (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. For purposes of applying this section to any amount includible in income by reason of section 593(e), the preceding sentence shall be applied without regard to the phrase '10-year'. `` (B) Special rule relating to election of corporation to be taxed as partnership.-- `` (i) In general.--In the case of an election under section 7701(a)(2)(B), subparagraph (A) shall be applied by substituting '25-year' for '10-year' both places it appears. `` (ii) Exception where 10-year period expired.--If, on the date of an election referred to in clause (i) by a corporation, the 10-year period specified in subparagraph (A) with respect to such corporation has expired, clause (i) shall not apply to such corporation.". (5) Effective dates.--The amendments made by this subsection shall apply to taxable years beginning after December 31, 2004. (c) Step Transaction Doctrine not to Apply to Partnership Incorporation Followed by Corporate Reorganization.-- (1) In general.--Section 351 of such Code is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection: `` (h) Special Rule for Partnerships Which Incorporate and Subsequently Reorganize.--The step transaction doctrine and any similar doctrine shall not apply for purposes of determining whether the control requirement of subsection (a) is met in any case in which-- `` (1) a partnership engaged in an active trade or business transfers substantially all of the property used in carrying on such trade or business to a corporation which is not publicly traded, and `` (2) such corporation subsequently enters into a reorganization under this chapter.". (2) Effective date.--The amendment made by this subsection shall apply to transactions after December 31, 2004. SEC. 3. PARTNERSHIP INCOME ATTRIBUTABLE TO CAPITAL EXCLUDED FROM NET EARNINGS FROM SELF-EMPLOYMENT. (a) In General.--Paragraph (13) of section 1402(a) of the Internal Revenue Code of 1986 is amended to read as follows: `` (13) there shall be excluded the distributive share of net income of a partner attributable to capital;". (b) Partnership Income Attributable to Capital.--Section 1402 of such Code is amended by adding at the end the following new subsection: `` (I) Partnership Income Attributable to Capital.-- `` (1) In general.--For purposes of subsection (a)(13), the following amounts shall be treated as income attributable to capital-- `` (A) the amount, if any, in excess of what would constitute reasonable compensation for services rendered by such partner to the partnership, and `` (B) an amount equal to a reasonable rate of return on unreturned capital of the partner determined as of the beginning of the taxable year. `` (2) Definitions.--For purposes of paragraph (1)-- `` (A) Unreturned capital.--The term 'unreturned capital' means the excess of the aggregate amount of money and the fair market value as of the date of contribution of other consideration (net of liabilities) contributed by the partner over the aggregate amount of money and the fair market value as of the date of distribution of other consideration (net of liabilities) distributed by the partnership to the partner, increased or decreased for the partner's distributive share of all reportable items as determined in section 702. If the partner acquires a partnership interest and the partnership makes an election under section 754, the partner's unreturned capital shall take into account appropriate adjustments under section 743. `` (B) Reasonable rate of return.--A reasonable rate of return on unreturned capital shall equal 150 percent (or such higher rate as is established in regulations) of the highest applicable Federal rate, as determined under section 1274(d)(1), at the beginning of the partnership's taxable

year. `` (3) Regulations.--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection." (c) Effective Date.--The amendments made by this section shall apply with respect to services performed in taxable years beginning after December 31, 2004.