

DOES ONE SIZE FIT ALL? SHOULD THERE BE A SINGLE SET OF FEDERAL INCOME TAX RULES FOR S CORPORATIONS AND PARTNERSHIPS?

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In March of 2013, as one of its tax reform discussion drafts, the House Ways and Means Committee released a draft of “Provisions to Reform the Taxation of Small Businesses and Passthrough Entities.”¹ Apart from provisions directed at small businesses² and changes to the due dates for business tax returns,³ the draft includes two options for the reform of the federal income tax treatment passthrough entities—that is, of partnerships and of S corporations.⁴ One option (described in the draft as “Option 1”) would keep the present two track system, but make specific changes to the separate rules that now apply to S corporations and partnerships,⁵ and the second would go much further and fundamentally redo the rules that now apply to S corporations and partnerships by creating a single set of rules that would apply to both partnerships and corporations if not publicly-traded (described in the draft as “Option 2”).⁶ The Option 1 changes would be incorporated in the Option 2 rules that would apply to passthroughs.⁷

The future of Option 2, and thus of fundamental reform of the taxation of passthroughs, is uncertain. The Senate Finance Committee has yet to weigh in,⁸ and comments on Option 2, as well as the testimony at the

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¹ WAYS & MEANS COMM., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (2013) [hereinafter TECHNICAL EXPLANATION].

² Examples of such provisions include the expensing of certain expenditures and the use of cash method accounting. *See id.* at 1–5.

³ *See id.* at 8–11.

⁴ *See generally id.*

⁵ *See id.* at 12–32.

⁶ *See id.* 33–66.

⁷ *Id.*

⁸ The Senate Finance Committee staffs have released a series of bipartisan papers setting out options for reform, including one that addresses entity classification rules. *See generally* SENATE FIN. COMM. STAFF, SENATE FIN. COMM., TYPES OF INCOME AND BUSINESS ENTITIES, SENATE FINANCE COMMITTEE STAFF TAX REFORM OPTIONS FOR DISCUSSION (2013) [hereinafter TAX REFORM OPTIONS FOR DISCUSSION]. The options list proposals made by others, including those in the Ways and Means Committee discussion draft, but take no specific position, although they do identify the payroll tax and other differences between the S corporations and partnerships as issues that should be discussed. *See generally id.*

hearings held on the draft by the Subcommittee on Select Revenue Matters, have not been enthusiastic.⁹

This article focuses on Option 2 and argues that, if there is change, it would be far more sensible to have a single set of passthrough rules than to simply make the Option 1 changes to the separate rules that apply to S corporations and partnerships.¹⁰ The two-track system came about for reasons that no longer justify two systems—specifically, because limited liability for the owners required incorporation. With the availability of limited liability companies, that is no longer the case. A one-track system

⁹ See George K. Yin, Tax Analysts, *Comments on the Taxation of Passthrough Entities*, TAX NOTES TODAY July 22, 2013, at 358 (referring to the 1999 ALI Reporters' Study); S CORP. ASS'N, THE S CORPORATION ASSOCIATION COMMENTS TO THE HOUSE COMMITTEE ON WAYS AND MEANS PASS-THROUGH BUSINESS WORKING GROUP 5 (2013) (endorsing the specific Option 1 changes and their inclusion in Option 2, but stating that “[o]n the other hand, the scale of the changes suggested under Option Two, together with the uncertainty and transaction costs they would impose on existing S corporations and partnerships, has the potential to outweigh whatever benefits the resulting unified pass-through regime offers”), available at http://waysandmeans.house.gov/uploadedfiles/s_corporation_association_wg_comments.pdf; Letter from Jeffrey A. Porter, Tax Comm. Chair, Am. Inst. of CPAs, to Dave Camp, Chairman, Sander M. Levin, Ranking Member, House Comm. on Ways & Means (July 30, 2013) [hereinafter Letter from Am. Inst. of CPAs], available at <http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/aicpa-option-2%20comments-7-30-13.pdf> (“the Option 2 one size-fits-all approach for taxing passthrough entities is not in the best interest of the business and investment communities or the taxpaying public”); see also *Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft: Hearing Before the Subcomm. on Select Revenue Measures*, 113th Cong. (2013) (statement of Thomas Nichols, Chairman of the Board of Advisors of the S Corporation Association). On the hearing, at which the author of this article also testified, see *Calendar Item*, COMMITTEE ON WAYS & MEANS, <http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=333107> (last visited Oct. 22, 2013).

¹⁰ Option 2 would not affect regulated investment companies or real estate investment trusts (except in so far as it makes permanent the five year gain recognition period for built-in gain, which applies to Regulated Investment Companies (RICs) and Regulated Investment Trusts (REITs), as well as the new passthrough regime) or, generally, the status of publicly-traded partnerships that are treated as partnerships for tax purposes because of the “good” income exception in I.R.C. § 7704(c) to the rule that generally treats publicly traded partnerships as corporations. I.R.C. § 7704(c) (2006). Those publicly-traded partnerships would henceforth be subject to the rules of new passthrough system. RICs, REITs and publicly-traded partnerships that are shareholders of a passthrough corporation would seem to be treated no differently than if today they were partners in a partnership. Since passthrough treatment of a corporation is elective, however, they could continue to use corporate subsidiaries, including taxable REIT subsidiaries, as “blockers.” Taxable mortgage pools may have to be addressed if Option 2 moves forward. A taxable mortgage pool is *per se* a corporation, but may not be publicly traded. *Id.* § 7701(i).

would also be much simpler, eliminating (among other things) the need to seek professional advice at the outset, as well as shareholder eligibility and one class of stock rules that, if not complied with, will cause the corporation to be taxed as a “regular” corporation. And objections to specific features of Option 2, such as the recognition of gain when a passthrough distributes appreciated property, do not justify two systems—those features of Option 2 could be changed, if that was the consensus, without keeping the two-track system. If reform does not go in the direction of Option 2, it is more likely to be because of concerns that Option 2 will inevitably lead to the reform of payroll taxes and the loss by S corporations of their payroll tax advantage than to the specific features of Option 2 or the concept of a single-track system.

I. S CORPORATIONS AND PARTNERSHIPS

The treatment of current income, gain and loss of partnerships and S corporations is substantially the same. Partnerships (which for federal income tax purposes include limited liability companies as well as general and limited partnerships) are exempt from federal income tax, and the partners take into account, as though earned or incurred directly, their shares of the income, gain, loss and expense of the partnership.¹¹ An S corporation is a corporation which, if it meets certain requirements and elects, is treated substantially the same as a partnership in respect of the taxable year’s income, gain, loss and expense—that is, the S corporation is exempt from tax and its income, gain, loss and expense pass through to the shareholders.¹² But outside of the treatment of current income, gain, loss and expense, there are significant tax differences between S corporations and partnerships. Of these, the most important are the differences in: (1) the treatment of distributions of property (which, because of the repeal of the *General Utilities* doctrine,¹³ result in gain in the case of an S corporation and its shareholders);¹⁴ (2) the ability to allocate specific items of income, gain, loss and expense among owners (which is generally not available to an S corporation because it may have only one class of stock); (3) the

¹¹ See *id.* §§ 701, 702.

¹² See *id.* §§ 1363, 1366. Partnership losses are limited to the owner’s basis in the partnership interest, which includes the partner’s share of partnership debt. In the case of an S corporation, however, they are limited by I.R.C. §1366(d) to the basis of the shareholder’s shares and of any debt from the S corporation to the shareholder. *Id.* § 1366(d).

¹³ *Gen. Utils. Co. v. Helvering*, 296 U.S. 200 (1935) (applying the general rule that a corporation recognized no gain or loss on the distribution of appreciated property to its shareholders which was later repealed by the Tax Reform Act of 1986).

¹⁴ A related consequence of the differences is that a “regular” corporation which wants passthrough treatment may be stuck if it is ineligible to be an S corporation (if, for example, it has a foreign shareholder) because conversion to a partnership will result in the recognition of gain by the corporation and its shareholders.

payroll tax rules (which apply differently to employees of a corporation and to partners of a partnership); and (4) who is eligible to own equity in a partnership or S corporation (which is not limited for a partnership but in the case of an S corporation is generally limited to individuals who are U.S. citizens or residents and specified trusts, estates and tax exempt entities).

Option 2 of the Ways and Means Committee discussion draft would eliminate all of these and most other differences between S corporations and partnerships by enacting a single set of rules for passthroughs, whether incorporated or not.¹⁵ It thus puts squarely on the table the question of whether it makes sense to have two sets of rules—one for partnerships and the other for S corporations—or whether one set would be an improvement. While there have been many proposals for reforming the rules that apply to partnerships and S corporations, few are as straight forward as Option 2 of the discussion draft.

The economic importance of S corporations and partnerships, and thus of changes in the tax rules that apply to these entities, is evident. While “regular” corporations continue to account for most business receipts in the United States, the number and importance of passthroughs—principally, partnerships and S corporations—has grown significantly over the last twenty years.¹⁶ In 1980, eighty-three percent of U.S. businesses were organized as passthroughs, accounting for fourteen percent of business receipts.¹⁷ By 2007, passthroughs accounted for ninety-four percent of U.S. business entities and thirty-eight percent of business receipts—a growth in their share of business receipts of about one percent a year for twenty-four years.¹⁸ The growth reflects a shift away from the use of “regular” corporations to S corporations and limited liability companies.¹⁹ There were more than four million S corporations and three million partnerships (of which 1.9 million were limited liability companies) in 2008.²⁰

¹⁵ See TECHNICAL EXPLANATION, *supra* note 1, at 33–66. All of these rules would take effect in 2014, without any grandfathered exceptions. STAFF OF H. COMM. ON WAYS & MEANS, 113TH CONG., STRENGTHENING THE ECONOMY AND INCREASING WAGES BY MAKING THE TAX CODE SIMPLER AND FAIRER FOR AMERICA’S SMALL BUSINESSES (Comm. Print 2013) [hereinafter STRENGTHENING THE ECONOMY AND INCREASING WAGES] (listing “[t]ransition rules . . . with a goal of minimizing disruption” as a so-far-“unaddressed” issue).

¹⁶ CONG. BUDGET OFFICE, PUB. NO. 4298, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX 1 (2012).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ See *id.* Sole proprietorships, limited partnerships, general partnerships and limited liability partnerships remained fairly constant. See *id.* at 8. From 1980 to 2007, the percentage of businesses organized as S corporations and limited liability companies grew from five percent to twenty percent. *Id.* at 8.

²⁰ See *id.* at 8–11. There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. See *id.* The shift from C corporations has

II. THE EVOLUTION OF THE S CORPORATION RULES

How should Option 2 be evaluated? One starting point might be the history of the S corporation rules—that is, how did we get to the two-track system that we now have.

The S corporation rules were enacted in 1958²¹ in order to eliminate federal income tax as a consideration in choosing an entity to conduct a business.²² At the time, there were no limited liability companies and limited partnerships could not avoid personal liability for individuals involved in the business. As a consequence, achieving limited liability for all the owners required the incorporation of the business. This was a tough choice—the highest individual tax rate in 1958 was ninety-nine percent²³ and the top corporate tax rate was fifty-two percent.²⁴ As a consequence, the tax burden of incorporation could be significant. The situation has, of course, changed. All States and the District of Columbia now have limited liability company statutes and, with the adoption of the so-called check-the-box regulations for 1997 and later years, there can be certainty that a limited liability company will be treated as a partnership for federal income tax purposes if it has more than one member, or disregarded altogether if it has only one member. Limited liability no longer requires incorporation and with that change, the original reason for the S corporation rules disappeared. It no longer makes sense to distinguish between incorporated and unincorporated entities.

The S corporation rules enacted in 1958 were subsequently amended a number of times (including in 1982 by the Subchapter S Revision Act and in 1986 by the repeal of what was left of the *General Utilities* doctrine).²⁵ The amendments generally loosened the rules by increasing the number²⁶ and type of permitted shareholders,²⁷ modifying the

contributed to the decline to about 10% in corporate tax revenues as a component of Federal tax revenues. *Id.* at 15.

²¹ Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1606 (1958).

²² See S. REP. NO. 85-1983, at 87 (1958) *reprinted in* 1958-3 C.B. 1008 (“[T]he enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence[s].”).

²³ See DANIEL BANEMAN & JIM NUNNS, URBAN-BROOKINGS TAX POLICY CTR., INCOME TAX PAID AT EACH TAX RATE, 1958–2009 (2012), *available at* <http://www.taxpolicycenter.org/UploadedPDF/901456-Tax-Paid-Each-Rate.pdf>.

²⁴ S. REP. NO. 85-1983, at 87.

²⁵ *Gen. Utils. Co. v. Helvering*, 296 U.S. 200 (1935); see Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

²⁶ Thus, over the years, the number of permitted shareholders went from ten to fifteen to twenty-five to thirty-five to seventy-five and then to 100 (with an election to treat a family as one shareholder).

²⁷ For example, to include most tax exempt organizations (although their S corporation income would be subject to the tax on unrelated business income

“passive income test,” eliminating any restriction on foreign source income or on being a member of an affiliated group, and permitting some banks to qualify.²⁸ The changes ameliorated the differences and, together with changes in the rates of corporate and individual taxes, started the significant growth in S corporations after the Tax Reform Act of 1986. However, they by no means eliminated the differences between S corporations and partnerships—specifically, the shareholder eligibility rules, the one class of stock requirement and the recognition of gain on property distributions. Nor did they address the different payroll tax rules that apply to employees of an S corporation and partners in a partnership, an issue that grew in importance with the growth of S corporations.

Whether or not the original reason for S corporations makes any sense today, do the substantive differences between S corporations and partnerships make a case for having two separate sets of rules? It seems clear that the significant differences between the rules resulted from choices made at the time the S corporation rules were enacted that could have been made differently and from subsequent changes in the Internal Revenue Code, such as the 1986 repeal of what was left of the *General Utilities* doctrine,²⁹ that were primarily directed at “regular,” not S, corporations. The differences do not provide persuasive reasons for having separate tax rules for S corporations and partnerships.

For example, the S corporation rules that were enacted in 1958 could simply have permitted a “small” business to elect to be a partnership. That would have eliminated any tax differences between S corporations and partnerships. This option, with some modifications, was in fact considered and passed by the Senate in 1954, but it was ultimately rejected because of the view that to do so would allow any built-in gain in the assets of an existing “regular” corporation that became an S corporation to escape corporate tax when realized and allow any accumulated earnings and profits of an existing “regular” corporation that became an S corporation to escape shareholder tax when distributed.³⁰ Addressing those issues by limiting the S corporation election to new corporations that had no built-in gain or accumulated earnings and profits was considered a bad idea because it would limit the effectiveness of the S corporation rules.

Was there a solution to the built-in gain and accumulated earnings and profits issues? Option 2 of the House Ways & Means Committee draft addresses the built-in gain and accumulated earnings and profits issues and,

unless an employee stock ownership plan). See I.R.C. §§ 1361(b)(1)(B), 512(3) (2006).

²⁸ See *id.* § 1361(b)(2)(A). These qualifying banks are those that do not use the reserve method of accounting for bad debts. See *id.*

²⁹ See 296 U.S. at 200.

³⁰ See generally S. REP. NO. 85-1983 (1958).

very sensibly and like the present S corporation rules,³¹ simply provides that the built-in gain is preserved and will be subject to corporate tax if recognized within five years after the election to be a passthrough and that distributions out of accumulated earnings and profits will be taxed to the equity owners.³² This could have been done in 1958.

Apart from concluding that, outside of the treatment of current income, expense, gain and loss, S corporations should be treated for tax purposes as corporations, not partnerships, the S corporation rules enacted in 1958 were drafted to avoid dealing with issues perceived to be difficult.³³ This approach is a major source of the differences between S corporations and partnerships. For example, the S corporation rules require that all shareholders be individuals who are residents or citizens of the United States or specified trusts, estates or tax exempt entities, thus excluding nonresident alien shareholders.³⁴ Why is that? Simply excluding foreign shareholders was an easy way to avoid the need to have rules that would impose tax on a foreign shareholder's share of the S corporation's income and collect that tax by withholding. That could have been done (albeit at the price of some complexity) with the partnership model, as subsequently supplemented by the partnership withholding tax rules.³⁵ The reason for the one class of stock rule is essentially the same—to avoid the difficulty of dealing with allocations of income, gain, expense and loss among the owners.³⁶

III. OPTION 2—IDENTICAL RULES FOR PASSTHROUGH CORPORATIONS AND PARTNERSHIPS

Option 2 of the Ways and Means Committee discussion draft would replace both the partnership and S corporation rules with a new set of rules

³¹ See I.R.C. §§ 1368(c), 1374.

³² STAFF OF H. COMM. ON WAYS & MEANS, 113TH CONG., DISCUSSION DRAFT TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO PROVIDE FOR COMPREHENSIVE INCOME TAX REFORM (Comm. Print 2013) [hereinafter DISCUSSION DRAFT].

³³ See generally *S Corporation Reforms: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 108th Cong. (2003) (illuminating some of the pitfalls of earlier versions of S corporation rules).

³⁴ See I.R.C. § 1361(b)(1)(C).

³⁵ A foreign partner in a partnership that is engaged in a trade or business in the United States is taxed on the partner's share of the effectively connected income of the partnership, including any gain from the sale of assets of that business. See *id.* § 704. Tax is withheld by the partnership under I.R.C. § 1446. *Id.* at § 1446.

³⁶ There is no meaningful discussion of the reasons for the rule in the 1958 legislative history, but the requirement was also in the 1954 legislation passed by the Senate and the discussion at that time focused on administrative ease and the possible problems created by having preferred stock with preferential rights to dividends. See S. REP. NO. 1622, at 119 (1954).

that would apply to partnerships that were not publicly traded³⁷ and be available to any corporation, other than those not eligible to be an S corporation under present law,³⁸ if it was not publicly traded and elected to be taxed under the new rules.³⁹ This would then be the exclusive passthrough regime for corporations and partnerships other than RICs and REITs. Option 2 would generally not change the definition of a partnership,⁴⁰ the definition of what is an “entity” that is subject to classification as a partnership or a corporation (such as a “cell” company); or the treatment of “disregarded” entities.

Under Option 2, an election by a corporation (whether a “regular” or formerly an S corporation) to be a passthrough would not be a taxable event⁴¹ (although the special rules that apply to passive income and built-in gain of, or distributions by, corporations with accumulated earnings and profits would, as modified under Option 1, remain).⁴² Thus, an S corporation could generally move into the new passthrough rules without interrupting its passthrough treatment, and a “regular” corporation that was not able to become an S corporation under present law, because it had ineligible shareholders, could become a passthrough without the current

³⁷ Or, if publicly traded, were still partnerships because of the “good” income exception in I.R.C. § 7704(c).

³⁸ An insurance company, a bank that uses the reserve method of accounting for bad debts or a DISC or former DISC. I.R.C. § 1361(b)(2). It would, however, be available to foreign corporations. See DISCUSSION DRAFT, *supra* note 32, at 29–30.

³⁹ *Id.* at 54. An existing S corporation would be deemed to elect unless it affirmatively elected not to be a passthrough corporation. See *id.* at 57. A passthrough election by a corporation could be revoked only with IRS consent. See *id.*

⁴⁰ As under present law, partnerships would not include unincorporated entities described in paragraphs (a), (b), or (c) of the I.R.C. I.R.C. § 761. For example, at the election of all the members, an organization availed of for investment purposes only, for the joint production, extraction or use of property or by dealers in securities for a short period for the purpose of underwriting or distributing a particular issue of securities. *Id.* Likewise, rules for joint ventures between a husband and wife, similar to those in I.R.C. § 761(f), would be retained. The family partnership rule in I.R.C. § 704(e) would be limited to individuals, thus putting to rest the taxpayer’s argument in TIFD III-E Inc. v. United States, 666 F.3d 836, 837 (2d Cir. 2012).

⁴¹ See DISCUSSION DRAFT, *supra* note 32, at 56–59.

⁴² That is, the rules that (1) tax passive income if the passive income of such a corporation is more than sixty percent of its gross income, (2) tax such a corporation on built-in gain if the property is disposed of within five years, (3) require a former “regular” corporation to keep an accumulated adjustments account in order to segregate “regular” corporation earnings and profits (and tax distributions out of that account as dividends) and (4) require the recapture of LIFO reserves when a “regular” corporation becomes a passthrough entity. *Id.* at 105–31. In addition, there would be no carryover of “regular” corporation losses to the passthrough entity or from a passthrough entity to a “regular” corporation. See *id.* at 105.

recognition of gain.⁴³ Nor would there be a taxable event if a passthrough corporation or partnership no longer qualified as a passthrough (e.g., it became publicly traded) and was henceforth treated as a “regular” corporation.⁴⁴ Whether a partnership that was or became publicly traded would be classified as a “regular” corporation or not would continue to depend on whether it met the “good” income exception to the rule that generally treats a publicly-traded partnership as a corporation.⁴⁵

In the case of an S corporation, the consequences of Option 2 would be the elimination of the one-class-of-stock and shareholder-level eligibility rules (not more than 100 shareholders, consisting of specified trusts and estates and exempt organizations, but otherwise only individuals who are U.S. residents or citizens). A “regular” corporation that previously was not eligible, because of the shareholder eligibility and/or one class of stock rules, could now have passthrough treatment if it was not publicly traded. The different treatment of debt to a shareholder of an S corporation and a partner of a partnership would also be eliminated.⁴⁶ The one class of stock requirement that applies to S corporations would be replaced by the more flexible distributive share rule that will apply to passthroughs.⁴⁷ What will happen to tax-free reorganizations or spin-offs is unclear and will depend on how the new rules are spelled out.⁴⁸

IV. OPTION 2—WHY WOULD S CORPORATIONS OBJECT TO OPTION 2?

Leaving aside the treatment of tax-free reorganizations and spin-offs, which is not resolved by the discussion draft, why would S corporations not embrace Option 2? Option 2 on its face would seem to be a

⁴³ See *id.* at 69–70.

⁴⁴ See *id.* at 105.

⁴⁵ See I.R.C. § 7704(c). A publicly-traded corporation could not move into new Subchapter K without a taxable liquidation since the passthrough election, in the case of a corporation, is available only if the corporation is not publicly traded. See DISCUSSION DRAFT, *supra* note 32, at 54. And thus publicly traded corporations that wanted to be passthroughs would, as today, choose to become REITs if able to qualify. See *id.*

⁴⁶ See STRENGTHENING THE ECONOMY AND INCREASING WAGES, *supra* note 15, at 5–6. That is, the “back-to-back” loan issue would be eliminated since debt of a corporation that was a passthrough would be treated in the same way as debt of a partnership passthrough and thus could be included in the owner’s basis for the ownership interest. See *id.* at 6. See the Ways and Means Committee release stating that Option 2 will “[c]onform [S corporations] to the basis rules that currently apply to partnerships” *Id.* at 6.

⁴⁷ See DISCUSSION DRAFT, *supra* note 32, at 61–69.

⁴⁸ In any event, the Subchapter C rules that now apply to reorganizations involving “regular” corporations would not be available. While there would be no more “QSubs,” disregarded entities would be available, as would passthrough corporations if treated in effect as disregarded entities. See generally TECHNICAL EXPLANATION, *supra* note 1.

significant improvement, giving S corporations significantly greater flexibility.

In answering this, it is important to focus on the growth in S corporations over the years. The view that S corporations exist to achieve limited liability does not explain their on-going popularity. In 2003, S corporations accounted for about sixty-two percent of all corporate income tax returns, reflecting a 36.3% increase in the prior six years, although C corporations continue to be used by small businesses.⁴⁹ Limited liability companies are also popular but there is no evidence that the availability of limited liability companies and the adoption of the check-the-box regulations for 1997 and later years have stopped the growth of S corporations.⁵⁰

There are a number of ongoing reasons for the popularity of S corporations that do not derive from limited liability and may explain why some S corporations may not be enthusiastic about Option 2.

V. PAYROLL TAXES

One reason is the different treatment of partnerships and corporations for payroll tax purposes.⁵¹ If there is a single passthrough system for federal income tax purposes, it would certainly be odd to continue to have two separate rules for Federal employment tax purposes—that is, FICA for employees of corporations and Self Employed Contributions Act (SECA) for partners in partnerships. The payroll tax issue is not addressed by the House Ways and Means Committee discussion draft.⁵² It is noted in the *Technical Explanation* and listed as a so-far-unaddressed issue in the Ways and Means Committee release that

⁴⁹ See Kelly Luttrell et al., *Integrated Business Data, 2003*, 26 SOI BULL. 47, 47–54 (2003). While S corporations represent a smaller percentage of the corporations with business receipts over five million dollars, they represent about thirty percent of those with business receipts over fifty million, an increase of about seven percent over the prior year (as opposed to about one percent for C corporations). *Id.* at 48; see also, the statistics in JOINT COMM. ON TAXATION, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY (2012) [hereinafter JCX-66-12].

⁵⁰ See Luttrell et al., *supra* note 49, at 47–54. Partnerships were a less popular choice than S corporations for businesses formed in each of the years 1997 through 2002, but pulled slightly ahead (42.6% vs. 39.4%) in 2003 with limited liability companies taking the lead in the case of partnerships and representing, in 2003, about forty-six percent of all newly-formed partnerships. *Id.*

⁵¹ Since I.R.C. § 706(c) (2006) is repealed, the reference to guaranteed payments in I.R.C. § 707(c) (2006) would be replaced by a reference to I.R.C. § 707(a) (2006) payments for services actually rendered to the passthrough other than in the owner's capacity as an owner. See DISCUSSION DRAFT, *supra* note 32, at 36–39.

⁵² See generally DISCUSSION DRAFT, *supra* note 32.

accompanied the discussion draft.⁵³ The release, however, seems also to acknowledge the need to align the rules when it says that Option 2 “requires new rules for the employment and self-employment taxes of owners.”⁵⁴

This could, of course, be a major issue for S corporations since they are perceived as offering the opportunity to limit the payroll tax base. A partner is subject to SECA on the partner’s net earnings from a trade or business carried on by the partnership.⁵⁵ While this may understate the value of the partner’s services in a period when there significant expenses, it may also hugely overstate the amount that represents reasonable compensation for services.⁵⁶ An employee of an S corporation, on the other hand, is subject to payroll tax on “wages,” which is meant to capture reasonable compensation but of course leaves a lot of room for interpretation. The different treatment of proprietorships, partnerships and S corporations has a major impact on the choice of entities,⁵⁷ and some would say that it is the principal reason for the continued popularity of S corporations.⁵⁸

Even in a case where the business involves simply providing services and there is no capital investment, the individual can use an S corporation to limit the tax base to “wages,” taking the view that, because of intangible values or otherwise, this is significantly less than the net earnings from the trade or business that would be taxed if there were no S corporation.⁵⁹ The uncertainty as to what is “reasonable” compensation encourages this. And, if the individual does not do this, but continues to

⁵³ See TECHNICAL EXPLANATION, *supra* note 1, at 37–41; STRENGTHENING THE ECONOMY AND INCREASING WAGES, *supra* note 15, at 7.

⁵⁴ STRENGTHENING THE ECONOMY AND INCREASING WAGES, *supra* note 15, at 7 (emphasis added).

⁵⁵ Treas. Reg. § 1.1402(a)–2 (as amended in 1974).

⁵⁶ In *Moorhead v. Comm’r*, 66 T.C.M. (CCH) 149, 151 (1993), for example, a ninety-two year woman who had inherited mineral leases that were subject to an operating agreement, and “needed some assistance to maintain herself and her household,” was nonetheless held to be engaged in the business of producing and selling gas, and the profits were held to be self-employment income.

⁵⁷ See Cherie J. Hennig et al., *S Corp Taxation: Level the Playing Field*, 139 TAX NOTES 435, 444 (2013).

⁵⁸ The employment tax rules may also influence the choice by some small businesses (*i.e.*, those whose marginal tax rate is fifteen percent or less) to operate as C corporations, thus limiting the employment tax to wages and taking advantage of the low rates on other income of the corporation. See Martin A. Sullivan, *The Small Business Love-Hate Relationship with Corporate Tax*, 186 TAX NOTES 1321, 1321 (2011) (reporting that twenty-three percent of the small business receipts were by C corporations, and attributing this in part to the low corporate tax rate on the first \$50,000 of taxable income and the low rate, *i.e.*, fifteen percent, on dividends); see also Richard Winchester, *Gap in the Employment Tax Gap*, 20 STAN. L. & POL’Y REV. 127, 135–38 (2009).

⁵⁹ See, *e.g.*, *Watson v. United States*, 668 F.3d 1008, 1018 (8th Cir. 2012), *cert. denied*, *aff’g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

operate the business as a sole proprietorship, his or her net earnings from self-employment may overstate what would be reasonable compensation for the work actually performed.

Related to the payroll tax difference between S corporations and partnerships is the different treatment of those entities for purposes of provisions such as the passive activity loss rule in section 1.469-5T and the net investment income tax imposed by section 1411 for 2013 and later years.⁶⁰ Absent contrary regulations under section 1411, income from an S corporation that is not wages will be excluded from the shareholder's net investment income tax base if the S corporation is not a "passive" activity with respect to the shareholder, thus exacerbating the present payroll tax divergence by providing a further incentive to be an employee of an S corporation rather than a partner in a partnership.⁶¹

How much revenue is involved in the lack of parity among S corporations, proprietorships and partnerships? Revenue estimates for legislation that would achieve some degree of parity are significant.⁶² Apart from that, employment and self-employment taxes are already a major component of the tax "gap," *i.e.*, the difference between what should be, and what is, paid on time. The most recent Internal Revenue Service estimate, based on 2006, is that seventy-two billion of the \$450 billion tax gap is from these taxes (of which fifty-seven billion dollars is attributed to the self-employment tax and fifteen billion dollars to FICA and FUTA).⁶³ Much of gap is simple non-compliance, but there are more principled or structural problems that lead to understatements of liabilities, and it is not clear whether issues such as the determination of what is "reasonable" compensation for an employee of an S corporation have been factored into the IRS's tax gap numbers.⁶⁴ Critics would say that, taking those issues into

⁶⁰ See Treas. Reg. § 1.469-5T. The tests to determine whether an individual materially participates in a business differ for limited partners of a partnership and shareholders of an S corporation. *See id.*

⁶¹ See, e.g., Michael Kosnitzky & Michael Grisolia, *Net Investment Income Tax Regulations Affecting Corporations*, 91 TAXES—THE TAX MAG. 63, 68–70 (2013). A limited partner in a partnership, however, may achieve the same result if successful in taking the view that the partner is a limited partner for purposes of § 1402(a)(13) but that the activity is nonetheless not a passive activity. *See id.* at 70; see also, N.Y. STATE BAR ASS'N TAX SECTION, COMMENTS ON THE APPLICATION OF EMPLOYMENT TAXES TO PARTNERS AND ON THE INTERACTION OF THE SECTION 1401 TAX WITH NEW SECTION 1411 (2011).

⁶² See JANE G. GRAVELLE, CONG. RESEARCH SERV., THE TAX REDUCTION AND REFORM ACT OF 2007: AN OVERVIEW (2008). According to Joint Committee estimates, over ten years, the American Jobs and Closing Tax Loopholes Act of 2010 would have raised \$11.249 billion and the Tax Reform and Reduction Act of 2007 would have raised \$9.4 billion. *Id.* at 7.

⁶³ See *Tax Gap for Tax Year 2006*, IRS.GOV (Jan. 6, 2012), http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf.

⁶⁴ See generally *id.*

account, the real “gap” is much larger and the significant revenue estimates made for the legislative proposals would bear that out.⁶⁵

The Ways and Means Committee discussion draft only mentions payroll taxes in passing and makes no proposal. There have, however, been a number of legislative proposals to limit the payroll tax differences between S corporations and partnerships and it is inconceivable that the adoption of Option 2 would not give these a big push.

Legislative proposals with respect to payroll taxes have generally sought to achieve parity of treatment among S corporations, partnerships and proprietorships providing services (and not, for example, to simply integrate the employment and self-employment taxes with the personal income tax), and to do so by treating S corporations like proprietorships and partnerships in the case of businesses that generate personal service income. The alternative of having a uniform “reasonable” compensation rule that applied to proprietorships, partnerships and all corporations has not been put forward in Congress, no doubt because of the complexity and administrative cost (as illustrated by litigated cases) of determining “reasonable” compensation.⁶⁶

The Joint Committee’s 2005 proposals, although not the first proposals,⁶⁷ are a good starting point for this approach.⁶⁸ They would treat all of the income of a partner in a service partnership as net earnings from self-employment and define such a partnership as one “substantially of whose activities involve the performance of services” in specified fields. The same rule (i.e., a partnership rule) would apply to shareholders of S corporations.⁶⁹ The proposal would, however, limit the tax base to reasonable compensation in the case of a partner that does not materially

⁶⁵ See Winchester, *supra* note 58, at 127. The gap reported by the I.R.S. for 2001 “substantially understates the true shortfall in collections of federal employment taxes.” *Id.* It has also be argued that the rules for collecting the tax are flawed because interest only accrues from the date of assessment against the individuals responsible for paying the tax, not from the period for which the tax was due. See T. Keith Fogg, *Leaving Money on the Table and Providing an Incentive not to Pay—The Story of a Flawed Collection Device*, 5 HASTINGS BUS. L.J. 1, 2 (2009).

⁶⁶ See, e.g., Thomas E. Fritz, *Flowthrough Entities And The Self-Employment Tax: Is It Time For A Uniform Standard?*, 17 VA. TAX REV. 811, 867 (1998).

⁶⁷ See STAFF OF J. COMM. ON TAX’N, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 71–105 (Comm. Print 2005). Prior proposals include the proposal by the Administration in 1993 to treat an S corporation shareholder’s share of the S corporation’s income from a service-related business (defined as health, law, education, etc.) as net earnings from self-employment if the shareholder owned more than two percent of the corporation and materially participated in its activities. See *id.* This was subsequently narrowed by Congress and in the end not enacted.

⁶⁸ See *id.*

⁶⁹ See Winchester, *supra* note 58, at 135–38.

participate in the trade or business of the partnership.⁷⁰ While the Joint Committee Staff acknowledged that the “reasonable” compensation issue would not be resolved by its proposal, it concluded that the issue would be relevant only if the individual did not materially participate in the trade or business and so would be limited in its application.

The Joint Committee model has been the base for most of the subsequent proposals,⁷¹ but the subsequent proposals have limited the scope of the change to smaller businesses (e.g., those that depend on the reputation and skill of three or fewer individuals) and in some cases, to taxpayers that earn more than \$250,000.⁷² The shortcomings of the proposals are obvious—parity would be limited to income from professional services, as defined, and to smaller businesses (and sometimes to higher income taxpayers). These proposals leave on the table a large population of S corporations, do not address the reasonable compensation issue for “regular” corporations and do not deal with partnerships or proprietorships in cases where net earnings from self employment overstates the value of the personal services rendered by the proprietor or partner. Proposals outside of those considered by Congress also have shortcomings.⁷³

⁷⁰ *Id.* at 148–49 (suggesting that the Joint Committee proposal should be extended to closely-held C corporations).

⁷¹ *E.g.*, The Tax Reform and Reduction Act of 2007, H.R. 3970, 110th Cong. § 3204 (2007); the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. (2010). It was passed by the House in May of 2010 but not by the Senate, in part because of the opposition of the American Institute of Certified Public Accountants. *See id.* For a summary of the several legislative proposals, see DONALD J. MARPLES, CONGRESSIONAL RESEARCH SERVICE, TAXATION OF PRIVATE EQUITY AND HEDGE FUND PARTNERSHIPS: CHARACTERIZATION OF CARRIED INTEREST, Congressional Research Service (Mar. 10, 2011). *See also* Kip Dellinger, *The Consequences of Compensation as a Tax Position*, TAX NOTES, June 25, 2012, at 1549; N.Y. STATE BAR ASS’N TAX SECTION, REPORT ON LEGISLATIVE PROPOSAL REGARDING EMPLOYMENT TAXES AND PROFESSIONAL SERVICE BUSINESSES (2010) (commenting on the payroll tax provisions of the American Jobs and Closing Tax Loopholes Act of 2010).

⁷² *E.g.*, Stop the Student Loan Interest Rate Hike Act of 2012, S. 2343, 112th Cong. (2012); The Narrowing Exceptions for Withholding Taxes Act of 2013, H.R. 3840, 113th Cong. (2013).

⁷³ *See* CONG. BUDGET OFFICE, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX 20 (2012). For example, the alternatives outlined in a recent Congressional Budget Office paper would change SECA but not affect the use of S corporations to reduce the FICA tax base—the paper seems to assume, contrary to the evidence, that the reasonable compensation standard applies to constrain shareholder-employees of S corporations from understating “wages” and that it is administrable. *See id.* Its proposals are directed solely at SECA and include, as alternatives, (1) replacing the limited partner exclusion by an exclusion for income derived from a business by a person who does not materially participate in the business; (2) limiting the SECA base to reasonable compensation (which, because it would eliminate income from capital, would reduce the SECA base by

If Option 2 were enacted, it would seem logical that payroll tax reform would make no distinction at all between businesses that were incorporated and those that were not, and thus that the reform would go significantly beyond the previous legislative proposals that are limited to smaller S corporations providing professional services. Whether that would mean an extension of the SECA rules to all passthrough corporations, without regard to size or business, or would mean a uniform “reasonable compensation” standard for all business, whether incorporated or not, the change would be much more significant than anything considered to date.

Partnerships do not offer the same payroll tax opportunity, except to the extent that an individual can use the limited partnership rule in Section 1402(a)(13), which provides exclusion from the SECA base for

the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.⁷⁴

The discussion draft would not seem to affect this,⁷⁵ but payroll tax reform would inevitably put on the table the question of why there should be a limited partner an exclusion from the payroll tax base if the limited partner participates materially in the passthrough’s business.

more than fifty percent); and (3) excluding capital income from the SECA tax base, with the amount of capital income determined by applying a notional rate of return to balance sheet capital assets. *Id.* at 18–23. Leaving aside the failure to address S corporations and FICA, the proposals have serious shortcomings—for example, the proposal to extend the reasonable compensation test to proprietorships and partnership is sensible only if there is much greater clarity than there is today on how to determine reasonable compensation; and the proposal to have a safe harbor determination of capital income leaves out intangible values, such as goodwill or reputation, which is a central issue in the case of many service businesses. *See id.*⁷⁴ I.R.C. § 1402(a)(13) (2006).

⁷⁵ *See generally* DISCUSSION DRAFT, *supra* note 32. Because of the draft’s repeal of the guaranteed payment rule, the Section 1402(a)(13) exclusion would presumably be based on payments made to an owner for services rendered in a non-owner capacity. *See id.* The Section 1402(a)(13) exclusion from the SECA base will otherwise remain. *See id.* An owner may also be an employee of a passthrough partnership and thus earn “wages” subject to FICA. *See* STRENGTHENING THE ECONOMY AND INCREASING WAGES, *supra* note 15, at 2 (“Provide certainty with respect to owners who actively participate in the business by allowing owners to be treated as employees of the business.”). The draft is also clear that an owner may be treated as an employee of the business, which is not the case today for a partner in a partnership. *See* James B. Sowell, *Partners As Employees: A Proposal Analyzing Partner Compensation*, TAX NOTES, Jan. 15, 2001.

VI. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A second concern may be the treatment of employee stock ownership plan (ESOP) shareholders of an S corporation. ESOPs are eligible to be shareholders of an S corporation and, under a special rule that is limited to ESOPs and does not apply to other tax exempt entities, do not treat the income of the S corporation as income from an “unrelated trade or business.”⁷⁶ The effect is to eliminate any current tax on an ESOP shareholder’s share of the income of an S corporation—that is, to defer any tax until there are distributions by the ESOP. Again, this is not addressed by the discussion draft, but there may be a legitimate concern that, if Option 2 moves forward, the special rules that apply to ESOP shareholders of an S corporation will no longer be available. The treatment of ESOPs is not consistent with that of other tax-exempt employee benefit plans and it is not clear why there should be a difference. This is an important issue for S corporations with ESOP shareholders—and there is an active ESOP lobby.

VII. IS THE END OF THE TWO-TRACK SYSTEM “DISRUPTIVE”?
IS IT A “SIMPLER” SYSTEM?

Finally, there is the question of whether eliminating the separate rules for S corporations would be disruptive and involve “compliance” costs, and whether this by itself is a reason to keep the present two-track system.⁷⁷ The argument that Option 2 would have this effect is odd, since an S corporation that moved into the new rules would not have to change anything it did—to be sure, it could then, if it wanted, have foreign shareholders and multiple classes of stock, but that would be purely optional and, in any event, is not disruptive.⁷⁸ Does it make sense, then, to say that there is a “compliance” cost in Option 2 for S corporations? To be sure, change would no doubt be disruptive for professionals who have mastered S corporations and partnerships and the reasons for choosing one rather than another, but that is a different issue and should not trump the need for sensible change.

Is it “simpler” to have a two-track system than a single system? That argument has also been used to justify keeping the separate S

⁷⁶ See I.R.C. §§ 512(c), 512(e).

⁷⁷ See Yin, *supra* note 9, at 358; Letter from Am. Inst. of CPAs, *supra* note 9 (“[W]e believe transition from the current . . . regimes into a single regime would result in significant complexity and corresponding costs.”).

⁷⁸ See Yin, *supra* note 9, at 362. To be sure, in the case of a partnership, there would be gain recognition on property distributions, but this is a change that Professor Yin agrees with, and he is also “very sympathetic to the goals” of reforming the partnership rules relating to allocations of income, gain, loss and expense. See *id.*

corporation rules.⁷⁹ The argument is also odd since the two-track system means that, as a first step, a start-up business should consult with a tax professional in order to choose the right track.⁸⁰ Is that “simplicity”? And are S corporation rules simple? The one class of stock and shareholder eligibility rules are written as cliffs, i.e., rules that if not met result in disqualification and taxation as a “regular” corporation.⁸¹ That is why, in the case of S corporations with multiple shareholders, it is standard practice to have carefully drafted shareholder agreements. There is a premium on professional advice in cases where a business is uncertain which track to choose because of the complex one class of stock and shareholder eligibility rules. That there are also structures which “work around” these constraints adds to the complexity.⁸² Additionally, there is the complexity in the S corporation rules that results from the need to make elections, from failures to elect on a timely basis⁸³ or from the need to classify failures as “inadvertent” under the relief rules that apply to failures⁸⁴—all essentially relating to qualification and requiring the IRS to opine.⁸⁵ And most of the many private rulings issued with respect to S corporations each year relate to these issues.

A. Option 2—Why Would Partnerships Object to Option 2?

What about partnerships? Subchapter K, which sets out the rules for partnerships, was enacted as part of the Internal Revenue Code of 1954.⁸⁶ Since then, however, the complexity of the partnership rules has grown exponentially, in no small part because partnerships have been perceived as offering the opportunity to shift gains and losses from one partner to another; to allocate income, gain, expense and loss among

⁷⁹ *See id.*

⁸⁰ Consider, for example, WILLIAM R. CHRISTIAN & IRVING M. GRANT, SUBCHAPTER S TAXATION (4th ed. 2000), a treatise for professionals, which devotes two of its eight Parts to the choice of entity and the requirements to qualify as an S corporation.

⁸¹ *Id.* ¶ 6.04. In contrast, for example, to the present partnership rules under which, if an allocation of income, gain, loss or expense did not have substantial economic effect, it would simply be adjusted to conform to the partners’ interests in the partnership. I.R.C. § 704(b).

⁸² *See* Treas. Reg. § 1.701-2(d) (as amended in 1995) (discussing a partnership between the foreign participants and the S corporation to avoid the shareholder eligibility rules); *see also*, Rev. Rul. 94-73, 1994-2 C.B. 198 (discussing a partnership between S corporations to avoid the numerical limitation on the number of shareholders and the one class of stock restrictions, reversing the position previously taken in Rev. Rul. 77-220, 1977-1 C.B. 263).

⁸³ *See* I.R.C. § 1362(b)(5) (relating to late elections).

⁸⁴ *See id.* § 1362(f).

⁸⁵ Consider, for example, Rev. Proc. 2013-30, 26 C.F.R. § 601.105, a thirty page revenue procedure which sets out the circumstances in which relief from the election requirements will be granted without a private ruling.

⁸⁶ I.R.C. § 701-771 (Hein Supp. 1953–1954).

partners solely for tax benefits; to defer or avoid gain by “disguised” sales; and, in general, as the first choice for any tax shelter. Apart from litigation, the response has been repeated amendments to the partnership provisions of the Internal Revenue Code and the related regulations, including regulations to address the abusive use of the partnership provisions of the Internal Revenue Code and the use of partnerships to achieve results inconsistent with other Internal Revenue Code provisions,⁸⁷ contributions and distributions of property that might have the effect of shifting gain or loss among partners;⁸⁸ distributions of property (i.e., marketable securities) that could indefinitely defer the gain of a distributee partner;⁸⁹ “disguised” sales; allocations of income, gain and loss that do not have “substantial economic effect”;⁹⁰ the need for entity-level partnership audits; and a host of other matters.

A number of the provisions of the Ways and Means Committee draft respond to these uses of partnerships—specifically “(1) new restriction on allocations of passthrough items to owners; and (2) importing the subchapter S rule, the recognition of gain by the passthrough, and the recognition of gain (and sometimes loss) by the owner on a distribution of property.”⁹¹ Because of these provisions (and the likely revision of the payroll tax treatment of limited partners claiming the benefits of I.R.C. § 1402(a)(13)) it is much easier to understand why partnerships—particularly those in real estate and other sectors, such as private equity, that use complex structures—may not like Option 2. It should be kept in mind, however, that these issues can be handled differently than in Option 2 and that the objections to the provisions in the discussion draft do not provide a basis for rejecting the one track system.

B. *Single Distributive Shares of Ordinary Income, Capital Gain and Tax Credits*

While the passthrough rules (i.e., what passes through to an owner, the retention of its character and source, etc.) are not changed by Option 2, an owner’s distributive share of items of partnership income, gain, loss and expense will henceforth be determined on the basis of its “economic interest” in the partnership.⁹² Separately, and regardless of whether an allocation is consistent with the owner’s economic interest, there can, under

⁸⁷ See Treas. Reg. § 701-2(b) (2006) (setting out the partnership anti-abuse rule); Treas. Reg. § 701-2(d) (setting out the abuse of entity rule).

⁸⁸ See I.R.C. §§ 704(c), 724, 737.

⁸⁹ See *id.* §§ 731, 737.

⁹⁰ See I.R.C. § 704(b).

⁹¹ Willard B. Taylor, *Subchapter S Out the Window? What’s Going On?*, TAX NOTES, May 27, 2013, at 1051.

⁹² TECHNICAL EXPLANATION, *supra* note 1, at 45.

the discussion draft, be only a single distributive share of items within each of three categories: ordinary items, capital gain rate items (which will include qualified dividends) and tax credits (other than the foreign tax credit). As an exception, an owner's distributive share of foreign income taxes (and thus the related deduction or credit) will be based on the owner's share of the passthrough items on which the foreign taxes were imposed.⁹³

The single distributive shares rule (which is intended to “[r]educe the use of complex structures to engage in tax avoidance”⁹⁴) will, for example, prevent the splitting between owners of ordinary deductions, such as depreciation, and ordinary income; of capital losses and capital gains; or of foreign and domestic source ordinary income.⁹⁵ That is a major change for partnerships—many of the illustrations in the current regulations relating to partnership allocations would be closed down before being evaluated to determine whether they have “substantial economic effect.”⁹⁶ Conversely, it may restrict the flexibility that partnerships now provide—for example, where a professional services firm has nonresident alien and U.S. partners and allocates foreign source income to the foreign partners.⁹⁷

While there is general agreement that the present “substantial economic effect” limitation on allocations among partners does not work

⁹³ This seems to be more or less the same as the rule now in Treas. Reg. § 1.704-1(b)(4)(vii)(a) (as amended in 2013), and it puts to rest structures like that in *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011).

⁹⁴ STRENGTHENING THE ECONOMY AND INCREASING WAGES, *supra* note 15, at 5. The draft statute contemplates that regulations will prevent the avoidance of the restriction on distributive shares, including through the use of passthroughs under common control. TECHNICAL EXPLANATION, *supra* note 1, at 46.

⁹⁵ *Id.*

Assume passthrough AB has 2 owners, A and B. The passthrough has the following items related to its leasing activities: \$100 of rental income and depreciation expense of \$50, for a net income of \$50 from the leasing activity. The passthrough also receives \$50 royalty income. A's economic interest in the passthrough is with respect to the leasing activity, while B's economic interest in the passthrough is with respect to the intellectual property giving rise to the royalty income. Thus, of the \$100 total passthrough net income, A and B each have \$50, or 50 percent each. For purposes of applying this section, A's and B's distributive shares of \$50 are each comprised of 50 percent of each ordinary passthrough item, specifically, \$50 of rental income (50 percent of the \$100 of rental income), \$25 depreciation expense (50 percent of the \$50 depreciation expense), and \$25 royalty income (50 percent of the \$50 royalty income).

Id.

⁹⁶ *See, e.g.*, Treas. Reg. § 1.704-1(b)(5) (as amended in 2013).

⁹⁷ *Id.* The release notes, however, that the “proper treatment of . . . foreign partners” is a so-far-unaddressed issue. *Id.*

well,⁹⁸ the discussion draft's single distributive share system is not a coherent alternative. It needs to be rethought. For example, there are holes in the single distributive share categories—where does tax-exempt interest fit in?⁹⁹ And the three categories focus on individual tax rates, which would not seem to make sense when there are corporate partners.¹⁰⁰ It is also unclear whether the single distributive shares rule is for one year or for longer. Shifting allocations, or transitory allocations that change from year to year are, of course, an important focus of the present “substantial economic effect” rules that apply to partnership allocations. Finally, it is unclear to what extent, apart from the single distributive shares rule, there will be a change in the present partnership allocation rules—the distributive shares still have to be tied to something, such as the owners' capital accounts, which is presumably what the “economic interest rule” will require. On the other hand, “substantial economic effect” is eliminated, and without elaboration of what “economic interest” means (beyond that it is to be determined on the basis of “all the facts and circumstances”), the effect of this is uncertain.¹⁰¹ The single distributive share rule is obviously much less important for passthrough corporations, since (under Subchapter S) they are now limited to one class of stock. With the changes made by Option 2, a corporation that elects into Subchapter K will be able to have more than one class of stock. This is important—S corporation banks, for example, have urged that they be able to issue preferred stock and that would be feasible under Option 2.¹⁰²

VIII. RECOGNITION OF GAIN WHEN APPRECIATED PROPERTY IS DISTRIBUTED

Apart from the single distributive share rule, a second reason why partnerships may object to Option 2 is that gain (but not loss) will be recognized by a passthrough entity on a distribution of property to the owners, and gain or loss would be recognized by an owner on the receipt of property distributed by the passthrough (but with the loss deferred until the

⁹⁸ See Andrea Monroe, *Too Big to Fail: The Problem of Partnership Locations*, 30 VA. TAX REV. 465, 513 (2011).

⁹⁹ Possibly in the ordinary income share, since that is “any passthrough item which is not in” another share—but does it make sense to combine tax-exempt interest with other ordinary income items? See TECHNICAL EXPLANATION, *supra* note 1, at 45.

¹⁰⁰ For example, in the case of a corporate owner, does it make sense to group dividends that are eligible for the dividends received deduction with net capital gain, which is taxed at the same rate as ordinary income?

¹⁰¹ Liabilities not mentioned in the TECHNICAL EXPLANATION would apply to passthroughs. See generally TECHNICAL EXPLANATION, *supra* note 1.

¹⁰² *Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities: Hearing before Subcomm. on Select Revenue Measures of the Ways & Means Comm.*, 113th Cong. (2013) (testimony of Willard Taylor).

termination of all of the owner's direct or indirect interest in the passthrough).¹⁰³ The basis in loss property to the owner could not exceed the owner's basis in the owner's interest in the passthrough.¹⁰⁴

This would also be a major change for partnerships, since under current law (and subject to restrictions), no gain is recognized by a partnership or a partner on the distribution of appreciated property.¹⁰⁵ The Ways and Means Committee release describes this change as intended to "prevent owners from gaming the tax system by using losses to reduce tax liability," to "ensure that taxes are paid on real, economic gains" and to "prevent the use of pass-through entities to shift gains and losses amongst owners with different tax profiles."¹⁰⁶

IX. OTHER OBJECTIONS?

Apart from the specific objections that S corporations and partnerships may have to Option 2, there are other provisions that may make both uneasy.

One is that Option 2 would require a passthrough to withhold tax, at a rate to be specified, on an owner's distributive share of the entity's net income (treating ordinary income and capital gain items separately) unless the income is already subject to withholding under the rules that imposes withholding tax on foreign partners in a partnership.¹⁰⁷ The new withholding tax is, according to the Ways and Means Committee release, intended to "close the tax gap"—presumably a reference to underreporting

¹⁰³ See TECHNICAL EXPLANATION, *supra* note 1, at 50.

¹⁰⁴ *Id.* at 51.

¹⁰⁵ See I.R.C. § 731 (2006).

¹⁰⁶ TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 6. Leaving aside the changes that would be made by Option 1 and are also included in Option 2, most of the other rules in the new passthrough system are described by the TECHNICAL EXPLANATION as "similar to," "consistent with" or "as in present law," with those in the existing partnership rules (e.g., the exclusions from passthrough classification in Sections 761(a) and (f), the basis limitation on an owner's share of loss, the nonrecognition of gain or loss on a contribution of property to a passthrough, the basis of the contributed property, the basis of the contributing owner's interest when there is a contribution, the character of gain or loss on contributed receivables, etc., transactions between passthroughs and controlling owners, the closing of a passthrough's taxable year and the determination of an owner's distributive share when the owner's interest in the passthrough changes). Likewise, the passthrough rules relating to built-in gain or accumulated earnings and profits of a C corporation that becomes a passthrough are described as similar to those that now apply when a C corporation becomes an S corporation. See TECHNICAL EXPLANATION, *supra* note 1, at 59–60.

¹⁰⁷ I.R.C. § 1446. It seems unlikely that the intention is to apply Section 1446 only to foreign partners in a partnership passthrough, as opposed to foreign owners of a passthrough, whether it is a corporation or a partnership, but this is not clearly stated. See *generally id.*

of income by owners of small businesses.¹⁰⁸ The new withholding tax will be treated as a distribution for the purpose of determining the owner's basis in the owner's interest and as tax paid by the owner.¹⁰⁹ The credit allowed to the owner for the tax withheld is refundable.¹¹⁰ The tax is treated as imposed on the passthrough entity under Section 11, which imposes corporate tax on "regular" corporations, and the failure to pay the tax is treated as a failure to pay estimated corporate income tax.¹¹¹

Related to the withholding tax is the question of whether income, gain and loss of a passthrough will henceforth be determined at the entity rather than the owner level. Because the new withholding tax is determined at the level of the passthrough entity, there is an entity-level determination of that tax and of the items that make up the amount subject to withholding.¹¹² This would seem to eliminate any owner participation in the determination of the base for the withholding tax. The point is unclear, however, since the Ways and Means Committee release asks whether the IRS should "be permitted to audit and assess tax liability at the entity level."¹¹³

A final issue for S corporations and partnerships—although it could be fixed if the draft moves forward—is the determination of when an entity is publicly traded and thus not eligible to be a passthrough. The *Technical Explanation* says that, in the case of a corporation, the definition of publicly traded is "intended to be broader than the definitions under present law," and the proposed definition refers specifically to Section 1273(b), relating to the calculation of original issue discount on debt instruments, as well as to the definition of publicly-traded partnerships in Section 7704.¹¹⁴ The

¹⁰⁸ See TAX REFORMS OPTIONS FOR DISCUSSION, *supra* note 8, at 6.

¹⁰⁹ See *id.*

¹¹⁰ *Id.*

¹¹¹ TECHNICAL EXPLANATION, *supra* note 1, at 66.

¹¹² *Id.*

¹¹³ TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 6. The new passthrough rules do not include the electing large partnership provisions of present law, set out in Sections 771–76, or the Administration's proposals with respect to audits of large partnerships. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 188 (2013). Nor does it mention the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audit provisions.

¹¹⁴ TECHNICAL EXPLANATION, *supra* note 1, at 48. The TECHNICAL EXPLANATION refers both to the Section 1273(b) and Section 7704 regulations. Under 26 C.F.R. § 1.7704-1(c)(1) (2013), interests not traded on an established securities market are publicly traded (as a general rule, and subject five safe harbors) if "taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market." *Id.* Trading on a secondary market or its equivalent generally requires readily available, regular and on-going opportunities to sell. 26 C.F.R. § 1.7704-1(c)(2) (2013).

Section 1273(b) regulations treat instruments as publicly traded if there is a sale or if they appear on a quotation medium.¹¹⁵ The rules focus on value and are very inclusive.¹¹⁶ The focus of the Section 7704 regulations is different, i.e., not on determining value but on whether there are readily available, regular and on-going opportunities to sell.¹¹⁷ The broader definition will limit the population of corporations and partnerships that can move into the new passthrough rules, possibly even excluding some existing S corporations and partnerships.

X. OPTION 1—SPECIFIC CHANGES TO THE PARTNERSHIP AND S CORPORATION RULES

What about Option 1? The specific changes in Option 1 are not new—they are essentially items that have been put forward for some time.¹¹⁸ In the case of S corporations, Option 1 would make most of the industry-backed changes that are in the S Corporation Modernization Act of 2013 and its predecessors.¹¹⁹ In the case of partnerships, Option 1 would make more significant changes, although still largely clean ups.¹²⁰ There is no single source for the partnership changes—a number are proposals that were put forward in a 1997 Joint Committee paper but not enacted as part

¹¹⁵ 26 C.F.R. § 1.1273-2.

¹¹⁶ Under the Section 1273(b) regulations, for example, debt can be publicly traded if at any time in a thirty-one day period beginning fifteen days after its issuance “there are one or more indicative quotes,” defined as being the case “when a price quote is available from at least one broker, dealer, or pricing service . . . for the property and the price quote is not a firm quote,” or if there is a sale of the instrument within that period. *Id.* § 1.1273-2(f).

¹¹⁷ *See id.* § 1.7704-1(c)(2)(iii).

¹¹⁸ TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 4.

¹¹⁹ S Corporation Modernization Act of 2013, H.R. 892, 113th Cong. (1st Sess. 2013), which would (1) permanently reduce to five years the gain recognition period for built-in gain, (2) eliminate the rule that disqualifies an S corporation if has accumulated earnings and profits and its passive income is more than twenty-five percent of its gross receipts for three consecutive years, (3) raise from twenty-five to sixty percent of gross receipts the threshold for taxing an S corporation that has accumulated earnings and profits on net passive income, (4) allow and electing small business trust that is an S corporation shareholder to have a nonresident alien as a potential current beneficiary, (5) allow an electing small business trust to take a charitable deduction under the rules that apply to individuals, (6) make permanent the reduced basis adjustment to a shareholder’s shares resulting from a charitable contribution by an S corporation of appreciated property and (7) extend the time for making an S corporation election to the due date for the filing of the corporation’s return. *See also* Letter from the A.B.A. Section of Taxation to the Senate Comm. on Fin. & House Comm. on Ways & Means (Apr. 10, 2013).

¹²⁰ *See* TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 4–5.

of the Taxpayer Relief Act of 1997 and others come from comments made over time by practitioners and academics.¹²¹

These principal changes made to partnership taxation by Option 1 (and which are also included in Option 2¹²²) are:

1. Elimination of guaranteed payments. On the basis that Section 707(a), relating to payments to partners not acting in that capacity, is sufficient, repealing Section 707(c), relating to guaranteed payments for services or the use of capital (because it has “created a great deal of uncertainty, confusion, and controversy”).¹²³ Payments would simply be distributions to a partner unless covered by Section 707(a).
2. Mandatory adjustment to partnership property basis. Eliminating the elections in Sections 734 and 743, so that an adjustment to the basis of partnership property to reflect a sale of a partnership interest by a partner or the distribution of property by a partnership is mandatory, not elective or dependent on the built-in loss in partnership property after the distribution being “substantial”¹²⁴; and applying these rules to tiered partnerships.¹²⁵
3. Elimination of time restrictions on “mixing bowl” provisions. Eliminating the seven-year restrictions on the “mixing bowl” rules (i.e., the seven year restrictions in Sections 704(c)(1)(B) and 737(b)(1)) on the allocation of pre-contribution gain or loss of property when the contributed property is distributed to another partner or other property is distributed to the contributing partner.¹²⁶
4. Broadening the “hot asset” rule. Broadening the “hot asset” rule in Section 751 so that it treats a distribution of inventory to a partner as a sale, whether or not the inventory has appreciated “substantially” and

¹²¹ See Taylor, *supra* note 91, at 1052, 1052 n.5 (citing STAFF OF J. COMM. ON TAX’N, 105TH CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES (Comm. Print 1997) [hereinafter JCS-6-97]); TECHNICAL EXPLANATION, *supra* note 1, at 20, 22, 29; William B. Brannan, *The Subchapter K Reform Act of 1997*, TAX NOTES, Apr. 7, 1997, at 121; John S. Pennell & Philip F. Postlewaite, *Subchapter K—Have the Joint Committee Proposals and TRA ’97 Given It a New Look?*, 87 J. TAX’N 325 (1997) (discussing the fate of the Joint Committee proposals).

¹²² Option 2 would also repeal, as “obsolete,” Sections 736 and 753, relating to payments in the liquidation of a retiring or deceased partner’s interest and the treatment as income in respect of a decedent of amounts received as a successor in interest to a deceased partner; and would extend the rule that limits a partner’s loss to the partner’s basis in the partnership interest to deductions for charitable deductions and foreign taxes taken as a deduction (which is the rule that applies to shareholders of an S corporation). See TECHNICAL EXPLANATION, *supra* note 1, at 22.

¹²³ See JCS-6-97, *supra* note 121, at 45.

¹²⁴ See *id.* at 27.

¹²⁵ See *id.* at 42.

¹²⁶ See *id.* at 41.

simplifying the definition of an unrealized receivable so that it includes any property to the extent of the amount that would be ordinary income on a sale.¹²⁷

XI. WHAT IS LEFT OUT OF OPTIONS 1 AND 2?

Options 1 and 2 leave out a number of proposals for change that have been made over the years. For example, there have been proposals to change specific partnership rules that are not included in Option 2, such as repeal or modification of the rule in Section 708(b)(1) that terminates a partnership if there are sales or exchanges of fifty percent or more of the partnership interests in a year;¹²⁸ making more inclusive the investment company definition in Section 721(b) and thus the circumstances in which gain will be recognized on a transfer to a partnership that has the effect of diversifying the transferor's holdings of securities;¹²⁹ and accommodating the problems faced by publicly-traded partnerships covered by the "good" income exception in Section 7704(c), such as the determination of distributive shares when interests are regularly purchased and sold and the treatment of interests in a publicly-traded partnership as securities for purposes of Section 1058. Another suggestion has been that passthrough treatment should automatically apply to a corporation that is not publicly traded, thus eliminating the option of choosing to use a "regular" corporation to carry on business.¹³⁰

Another important issue is when a passthrough's activities will be attributed to its owners.¹³¹ This is important in a number of contexts, including where there are foreign or tax-exempt owners. Where there are foreign owners, for example, the present partnership rules (1) treat a foreign partner in a partnership as engaged in a U.S. trade or business if the partnership is so engaged¹³² and (2) treat a sale of an interest in a partnership as a sale of the partner's share of the assets of the partnership that are effectively connected, whether because of FIRPTA or otherwise.¹³³ The Ways and Means Committee release lists the treatment of foreign

¹²⁷ See *id.* at 43.

¹²⁸ *Id.* at 40.

¹²⁹ See N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON INVESTMENT COMPANY PROVISIONS: SECTIONS 351(E) AND 368(A)(2)(F) (2011).

¹³⁰ See Yin, *supra* note 9, at 359 ("It would prevent taxpayers from using C corporations as tax shelters in light of current and future disparities in the tax rates applicable to individuals and corporations.").

¹³¹ See TECHNICAL EXPLANATION, *supra* note 1, at 53. New Section 711(b) provides for a passthrough of the character of items but this may fall short of attributing the activities of the corporation to its owners. *Id.*

¹³² See I.R.C. § 875(1) (2006).

¹³³ Rev. Rul. 91-32, 1991-1 C.B. 107. This would be codified by the Administration's fiscal 2014 budget proposals. See DEP'T OF THE TREASURY, *supra* note 113, at 57.

owners as a so-far-unaddressed issue.¹³⁴ It would be odd, however, if the rules differed for a passthrough corporation and a passthrough partnership, and aligning the rules would offer an opportunity to achieve parity between foreign partners and foreign shareholders by, for example, making the withholding tax a definitive tax (and no longer treating a partner as engaged in business in the United States because the partnership was so engaged).

If there are tax-exempt owners of a passthrough, it seems clear that the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the "modifications" to the tax on unrelated business income or from the other operations of the passthrough.¹³⁵ This is, of course, the rule that now applies to partnerships. The Ways and Means Committee release asks whether the withholding tax should be applied to "tax-indifferent owners, such as pension funds"¹³⁶—it would seem that it should (although possibly in a modified form), so long as there is a tax on unrelated business taxable income.

And finally, what about foreign operations of passthroughs? The discussion draft does not address the disparity in the treatment of foreign income that will result if (as the Ways and Means Committee has proposed) active foreign income of a C corporation's foreign subsidiaries will be eligible for a ninety-five percent dividends received deduction—no dividends received deduction would be allowed to a passthrough. This is a difficult issue since, if dividends are taxed at capital gains rates, the effective U.S. tax on foreign earnings will be significantly less for a C corporation than for a passthrough, although that will of course depend on what happens to individual and corporate tax rates. The Ways and Means Committee release also lists the taxation of foreign operations as a so-far-unaddressed issue.¹³⁷

XII. CONCLUSION

In evaluating Option 2, it is important to distinguish between the basic approach of a single system and the specific features of that system. For example, requiring the recognition of gain on distributions of appreciated property, which borrows from the present S corporation rules, could go in the other direction and follow the present partnership rules. Objecting to a one-track approach on the basis of that or other specific

¹³⁴ TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 7.

¹³⁵ See Rev. Rul. 74-197, 1974-1 C.B. 143.

¹³⁶ TAX REFORM OPTIONS FOR DISCUSSION, *supra* note 8, at 7.

¹³⁷ *Id.*

features does not respond to the question of whether a one-track approach is better than the existing two-track system.

The one-track system put forward in Option 2 is far better than continuing the two-track system with some changes. It is unquestionably simpler. It eliminates the need to have upfront, professional advice as to which track is better, as well as the possibility that the choice was wrong and the business is now stuck. Nor is the greater flexibility that corporations will have under Option 2 complexity—having more than one class of stock or foreign shareholders are options, not requirements.

Would the enactment of Option 2 slow the growth in passthroughs? Whatever the criticisms of Option 2, a “regular” corporation would not seem to be a better choice for small business. And, if Option 2 was enacted, concerns about payroll tax reform notwithstanding, S corporations, which have been the leading choice for privately-held businesses, would likely find the new passthrough rules more accommodating than Subchapter S. The complexity of new passthrough rules—e.g., the possibility of special allocations within the single distributive share rule¹³⁸—is purely optional and is unlikely to be a deterrent. If small C corporations (those with less than \$100 million of assets) were to become passthroughs, passthroughs would account for more than fifty percent of total business receipts—and there are corporations that are trapped in Subchapter C because, for example, they have ineligible shareholders and would incur significant costs in liquidating and operating as a partnership.

What happens, of course, will depend in part on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes. If the rate of corporate tax is reduced to twenty-eight percent or twenty-five percent, and individual rates, which are already at the top above the corporate tax rate, remain unchanged, “regular” corporations may be perceived as a tax shelter, particularly if there continues to be lower rates on the first \$75,000 of taxable income.

¹³⁸ *Id.*

