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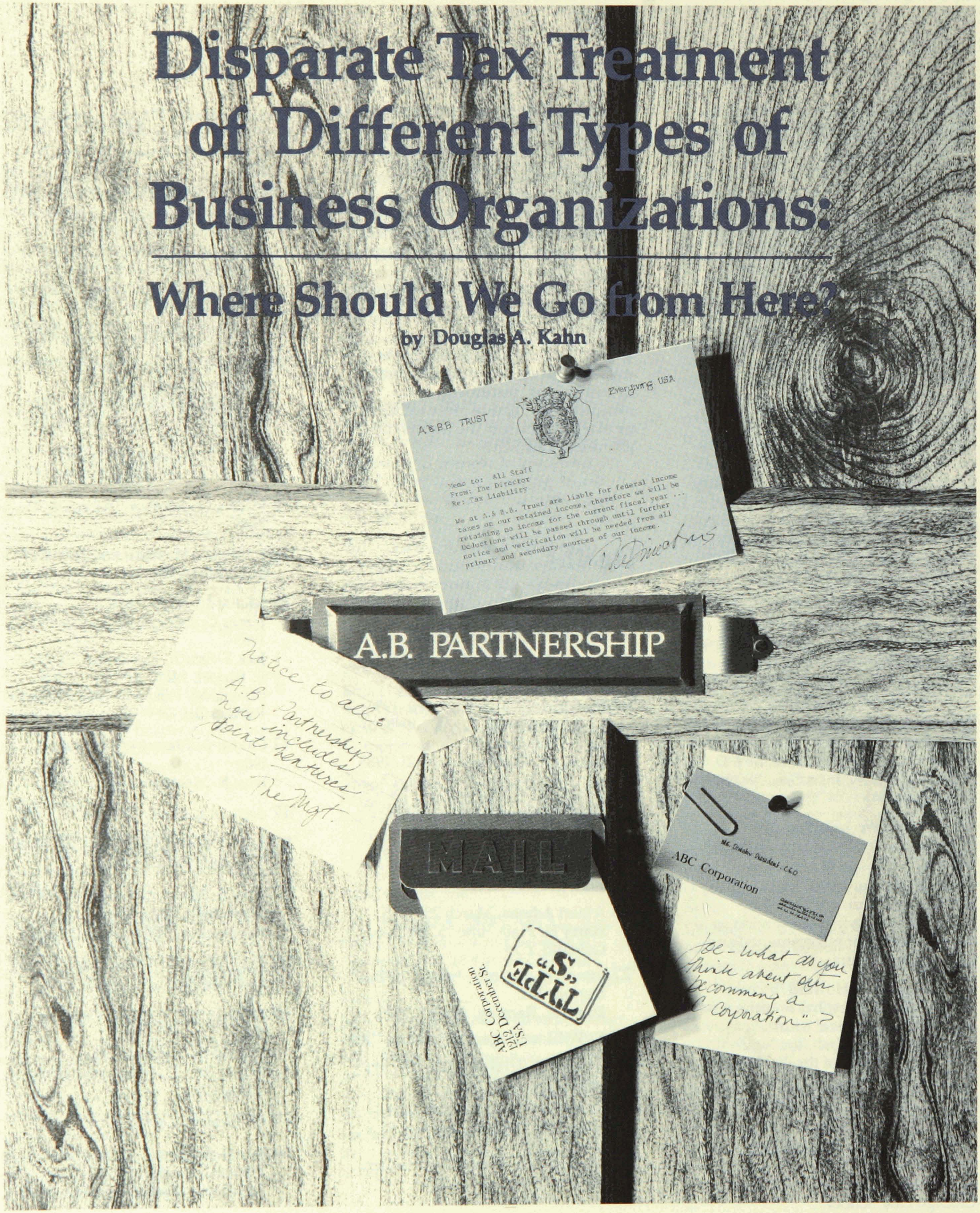
Where Should We Go from Here?

by Douglas A. Kahn



If several persons wish to join together in a common enterprise in order to pool their capital or labor or some of each, they may choose among a variety of available organizational structures that will serve that purpose. The most common entity forms are partnerships (including joint ventures), corporations, and trusts. While, in its typical structure, each of those entity forms has its own distinct characteristics, the structure of such organizations often is modified by agreement so as to adopt attributes of another type of entity. Because of this, the substantive distinction between entity types is blurred.

However, tax law's treatment of these entities is dissimilar in many important respects. For example, partnerships pay no federal income taxes. In this respect, the partnership serves as a conduit in that all of its income, losses, deductions, credits, and other tax attributes are passed through to its partners who report those items on their own tax returns. A corporation, on the other hand, is subject to a federal income tax. The typical domestic corporation is taxed on its income regardless of whether it retains that income or distributes its earnings to its shareholders by way of dividends. Corporate income is sometimes said to be subjected to a double tax—once when earned by the corporation and again when distributed to its shareholders. Certain closely held corporations are permitted to elect under Subchapter S to be excused from income tax liability on most (or perhaps all) of their income and to have most (or perhaps all) of their income, deductions, credits, and other tax items pass through to the corporation's shareholders in a manner that is similar to the pass-through treatment provided for partnerships and partners. Such electing corporations are referred to as "S Corporations." Corporations which are not S corporations are sometimes referred to as "C Corporations." Unlike a partnership, an S corporation is subjected to federal income lax liability in certain narrow circumstances, but for the most part, an S corporation will pay no federal income taxes.

A trust is liable for federal income taxes on its retained income, but to the extent that the trust makes (or is required to make) a current distribution of its income to its beneficiaries, such income will be taxed in the hands of the beneficiaries rather than the trust. Thus, a required or actual distribution by a trust will cause all or some of its income to be passed through to its beneficiaries, but the remaining trust income is taxed to the trust itself. Credits generally pass through to the beneficiaries. Deductions sometimes pass through and sometimes are available only to the trust.

The foregoing cursory description of entities and their tax treatment raises several fundamental questions. Should the tax treatment of all entities be the same or should there be disparate treatment? If there is to be disparate treatment, should the treatment depend upon the traditional classification of entities as corporations, partnerships, or trusts? If so, should the tax law's characterization of an organization rest on its characterization for local law purposes or should characterization be determined according to a federally established standard? Alternatively, should the tax characterization of an organization turn exclusively on an election by the members of the organization?

The tax law's current response to those questions is to characterize organizations according to federally created standards and to treat each entity type differently. Thus, an organization that is treated as a partnership for state law purposes may be treated as an association taxable as a corporation for tax purposes. The standards employed in determining the tax classification of entities were established in the Supreme Court's 1935 decision in *Morrissey v. Commissioner*, and they are sometimes referred to as the *Morrissey* standards.

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The history of the government's application of the *Morrissey* standards to partnerships is instructive in that there were dramatic shifts in the government's position as the benefits and detriments to taxpayers of corporate tax treatment waxed and waned. Initially, the government sought to impose corporate tax treatment on partnerships to the extent that it could do so under the *Morrissey* standards. The government's purpose was to maximize the reach of the double tax imposition that applies to corporate entities but not to partnerships. However, there are tax advantages to corporate treatment that mitigate or even offset the double tax cost.

Until recently, one of the tax advantages of corporate classification was a more liberal statutory deferred compensation treatment for shareholder-employees of a closely held corporation than was available to members of a partnership. Beginning with the early 1950s, many closely held organizations were incorporated for that purpose. Since, at that time, state laws prohibited professionals from incorporating, some professional partnerships successfully sought to be classified under the *Morrissey* standards as associations that are treated as corporations for tax purposes. To combat that effort, in 1960, the government promulgated regulations which adopted the *Morrissey* standards but construed them in such manner as to make it difficult for a partnership to be treated as a corporation. Many states responded to the 1960 regulations by authorizing professionals to incorporate, and so was born the "professional corporation." The government then promulgated a regulation which set forth standards for corporate characterization that were designed to exclude professional corporations. After a number of courts held this "anti-professional corporation" regulatory provision to be invalid, the government revoked it in 1977.

Subsequently, the statutory provisions for deferred compensation were altered by Congress so that there is little difference between the provisions for self-employed participants and those for employees. That change removed one of the major incentives for corporate characterization.

The focus of the characterization dispute shifted once again. With deferred compensation plans no longer a significant consideration, the government turned its attention to the area of tax shelters. Tax sheltered investments are designed to provide sheltered income for the investors or generate deductions or credits that the investors can use to shelter outside income. A corporation typically is not a useful entity for the conduct of a tax sheltered operation since the tax benefits generated by the corporation will not pass through to its shareholders. In some cases, an S corporation can be useful, but the requirements for qualifying as an S corporation are such that few tax shelter operations could qualify. Consequently, a partnership, especially a limited partnership, form has been the most popular entity for conducting such investments.

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The government had sought through legislative proposals and through litigation to eliminate tax shelters or to minimize the tax benefits which such investments are designed to obtain. To the same aim, the government has sought to prevent investors from securing such tax benefits by recharacterizing the partnership or trust which conducts the sheltering activity as a corporation for tax purposes. Thus, the government has returned to its pre-professional association position of seeking to impose corporate characterization to the broadest extent possible. As to partnerships, the government's litigating efforts were thwarted by the regulations it adopted in 1960, which are designed to make corporate characterization more difficult to obtain and therefore to impose. In its 1976 decision in *Philip G. Larsen*, the Tax Court established criteria that make it extremely difficult to reclassify a partnership as a corporation, and the Commissioner was constrained to adopt the *Larsen* position. As a result, relatively few limited partnerships are at risk of being reclassified, and general partnerships are virtually immune.

Trusts are also vulnerable to reclassification for tax purposes. In fact, the *Morrissey* case itself involved the classification of a trust as an association taxable as a corporation. The government has recently promulgated proposed regulations and rulings that would reclassify certain types of trusts, but, these rules have not yet been tested in court.

In general, incorporated organizations have withstood any effort to reclassify them as partnerships or other unincorporated entities. However, problems similar to characterization have plagued corporate entities. In some circumstances, persons who wished to do business as a partnership or as a sole proprietor have had to incorporate an activity to satisfy (or to avoid) some state law requirement. The most common illustration of this is where a real estate operation incorporates to obtain a construction loan and permanent financing. State usury laws do not apply to corporate borrowers. If the permissible rate under the usury law is lower than prevailing commercial rates, the lender will only make the loan to a corporate borrower. To comply with the lender's demand, the land is placed in a newly formed corporation which then borrows the funds needed for construction. In such cases, the charter of the corporate borrower may describe it as a "dummy" that was created solely to borrow the funds needed for construction. The corporation will be liquidated as soon as construction is completed and the permanent financing is obtained. The shareholders have then attempted to treat the incorporated entity as a sham so that the entity will be ignored for tax purposes and the organization treated as a partnership or sole proprietorship. With few exceptions, shareholders have been unsuccessful in such attempts, and the courts have sustained the viability of the corporate entity. To obtain partnership treatment in such cases, the shareholders will have to liquidate the corporation which may cause them to incur substantial tax liability especially if the corporation is deemed to be a collapsible corporation.

Faced with the Commissioner's and the courts' unwillingness to treat such real estate corporations as shams, shareholders tried a different approach. They formed a corporation to serve as an agent for the shareholders, and they transferred title to the realty to the corporation in its agency capacity. By so structuring the transaction, they hoped to permit the corporation to borrow the needed funds without saddling the operation with corporate tax treatment. It is a matter of state law whether such an arrangement will successfully evade usury law restrictions.

The Commissioner generally challenges the validity of such agency relationships and contends that the corporation is to be treated as the owner of the realty which it purportedly holds as agent for the transferors. The criteria for determining whether the agency relationship is valid were set forth in the Supreme Court's decision in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949). *National Carbide* established six standards or criteria of which the fifth has proven to be the most important. The fifth standard requires that a corporation's agency relationship with its principals not be dependent on their shareholder status for the agency relationship to be treated as valid. Although the Tax Court disagrees, several courts of appeals (the Fourth and Fifth Circuits) have held that the fifth standard must be satisfied to obtain agency status regardless of whether the other five *National Carbide* standards are met. The Fourth and Fifth Circuits have construed that fifth standard so strictly as to make it difficult for a corporation to qualify as an agent of its shareholders. However, if the transferors of the realty to the corporate agent are not the shareholders of the corporation, or if the shareholders own only a portion of the equity interests in the transferred property, the validity of the agency relationship likely will be recognized. E.g., *Moncrief v. United States*, 730 F.2d 276 (5th Cir. 1984). So, if a law firm were to form a corporation which serves as an agent of the firm's clients, it appears that the firm could borrow the needed funds and construct the property without subjecting its principles to corporate tax treatment.

The various tests employed to determine the characterization of an organization are designed to measure the extent to which an organization's attributes more closely resemble those of one type of entity rather than another. Thus, if the characteristics of an organization that is classified as a limited partnership under state law more closely resemble the attributes of a typical corporation, the organization will be treated as an association taxable as a corporation. Given that purpose, there are reasons to question whether the *Morrissey* standards are appropriate criteria especially in light of the diversity of forms that are now employed for each of such entities. But a more fundamental issue is whether the reclassification of entities is justified as a matter of tax policy. In other words, there may be no good reason for tax law to classify an entity as anything other than the classification chosen by the taxpayers regardless of the entity's characteristics.

The various tests employed to determine the characterization of an organization are designed to measure the extent to which an organization's attributes more closely resemble those of one type of entity rather than another.

First, let us consider whether there is any justification for reclassifying a limited partnership as a corporation. The corporate income that is distributed to a shareholder typically is subjected to double taxation—once in the hands of the corporation and again when it is distributed to a shareholder. There is substantial support for the view that this double taxation of corporate income is undesirable both for reasons of economic policy and of equity. If it were administratively feasible, it would be desirable to integrate the corporation's income with the individual shareholder's personal income and apply a single tax. The Subchapter S provisions demonstrate that in circumstances where the administration of an integrated tax system is manageable, Congress has permitted an election to integrate. The principal differences between the Subchapter S provisions and the provisions of Subchapter K (the partnership provisions) are those provisions of Subchapter S that are designed to prevent a perceived abuse where the S election is made by a corporation that had previously been operating as a C corporation. Congress feared that otherwise the shareholders could obtain the future income of the organization free of a corporate tax without first having to liquidate the corporation and cause the shareholders to recognize gain thereby. The provisions in Subchapter S that deal with this problem apply only to capital gains and to passive investment income.

So long as the allocation of partnership income among the various partners is administratively manageable, there is no reason to impose a double tax on partnership income. The integration of such income with that of the partners, as is done by Subchapter K, is unobjectionable. Since a corporate organization cannot be converted to a partnership without liquidating the corporation, the special Subchapter S problems concerning capital gains and passive investment income do not arise in the partnership area.

The major concerns over the classification of limited partnerships arise because of a partnership's capacity to pass through to its partners favorable tax attributes such as artificially created tax losses and tax credits. The partnership is the favored entity of the infamous tax sheltered investments. Tax shelters are spawned by tax preferences that typically are deliberately created by Congress for some economic or social purpose—e.g., highly accelerated depreciation and investment tax credits. If these preferences are designed to encourage certain types of investments, it would seem appropriate to permit the investments to be made by a group of people joining together as well as by a single investor. Indeed, there has been no objection to a general partnership's engaging in a tax sheltered investment. The attack has been directed at limited partnerships because limited partners have no liability to contribute additional amounts to the partnership or to pay its creditors.

A major objection has been raised to providing a person tax benefits, such as depreciation deductions, in an amount that exceeds the aggregate contributions of that person to the enterprise plus the total liability of that person for additional contributions. This situation can arise as a consequence of the "basis" rules that comprise the so-called *Crane* doctrine for the treatment of nonrecourse debt. The problem caused by nonrecourse debt is not peculiar to limited partnerships; it can arise where any party, even a single individual, acquires property subject to a debt for which the acquiring party is not personally liable. There is no reason to deprive a limited partner of the tax benefits that flow from the partnership's basis in property acquired through a nonrecourse debt. No property owner—general partner or sole investor—has any greater liability for the repayment of a nonrecourse debt than does a limited partner. Current law recognizes this, and treats a limited partner the same as a general partner in determining the bases that they acquire in their partnership interests as a result of the partnership's nonrecourse debt.

That is not to say that the current treatment of nonrecourse debts is correct. It is merely that there is no reason to distinguish limited partnerships from other investors in dealing with such debts. There are some who believe that the *Crane* rule should be modified or even repudiated. Regardless of the merits of that contention, the problem arises out of the *Crane* doctrine, and it is that doctrine that should be addressed directly rather than making a piecemeal attack on it by reclassifying some partnerships as corporations.

Another means of dealing with the nonrecourse debt problem is the imposition of "at risk" rules such as those imposed by §465 and §46(c)(8) of the Code. Currently those rules are insufficient because there are several areas where they do not apply—notably, real estate investments. The pending tax reform bill (H.R. 3838) would cure that problem by expanding the scope of the at risk rules so that they apply to many (but not all) real estate holdings. The bill also would repeal the investment tax credit and reduce the permissible rate of depreciation.

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The partnership's recourse debts do not open any doors to avenues for tax abuse. A limited partner enjoys limited liability as to the partnership's recourse debts. A partner can deduct his share of partnership losses only to the extent of his outside basis in his partnership interest (§704(d)), and a limited partner gets no addition to his outside basis because of a partnership's recourse debts. Consequently, a limited partner's exemption from liability precludes him from obtaining any tax benefit from such debts, and no tax abuse can occur because of such debts.

In sum, there is no justification for the Commissioner or the courts to challenge the classification of a partnership. The Commissioner has used reclassification as an oblique attack against tax provisions that the Commissioner deems undesirable where a frontal attack on such treatment does not seem promising. While the Commissioner's behavior is understandable, it would be more efficient and equitable to require either the courts or the legislature to face the underlying problem directly rather than to dilute its significance through the reclassifying of a relatively few organizations.

Similarly, it is inappropriate to impose extraordinary requirements for a corporation to qualify as an agent of its shareholders. The Tax Court has come to that conclusion, but the Commissioner rejects it, and he has the support of the Fourth and Fifth Circuits. It is especially inappropriate to impose such requirements where knowledgeable parties easily sidestep this obstacle by having a corporation which is formed and controlled by the shareholders' lawyers hold the property as the transferors' agent and obtain the needed financing.

For the same reasons, the characterization of a trust should not be challenged regardless of whether the beneficiaries have different types of interests in the trust. One problem here is that persons might be able to create a trust to which they each contribute their stock holdings in order to diversify their portfolio without recognizing a gain as would be required by §351(e)(1) or §721(b) if the transfers were made to a corporation or to a partnership. But, that problem exists for fixed investment trusts that the regulations acknowledge cannot be reclassified. [Treas. Reg. §301.7701-4(c)]. If this is a problem, it should be dealt with by amending Subchapter J rather than by attempting to reclassify some trusts.

Another reclassification issue arises where two or more persons acquire property as co-tenants and divide the income from the property among themselves. In some circumstances, the Service will seek to impose partnership status on that activity, which classification can have detrimental consequences to one or more of the parties. The only justification for imposing partnership status is to facilitate administration of the tax laws. It would seem that reclassification as a partnership should not be imposed unless the nature of the cooperative activity is such that it would be cumbersome to deal with it as representing an aggregate of interests rather than as a separate entity. However, in determining whether a tenancy in common should be reclassified, neither the courts nor the Service has addressed that question and instead they seek to resolve this issue according to mechanical standards that do not appear to be particularly relevant.

On the other hand, where several persons attempt to characterize an employment or loan arrangement as a partnership, the government has a legitimate interest in ignoring their formal characterization. This is to prevent the transmutation of compensation for services or for the use of funds, which would be ordinary income to the recipient, into a "partnership distribution" which may permit a deferral of income or capital gains treatment. Precluding partnership treatment is one means of preventing such abuses.

Two questions more fundamental than entity reclassification are whether there is any justification for having two different tax schemes for business organizations (i.e., a double tax system and a pass-through tax system) and, if so, whether the choice of the applicable system should depend upon whether the organization is a corporation or a partnership. Regarding the first question, as previously noted, an ideal tax structure would integrate all business income with the personal income of the individuals who have the beneficial interest in the organization. The major objection to a fully integrated system (i.e., a pass-through tax structure) is that the forms of equitable ownership of a corporation can be extremely complex. For example, different classes of corporate stock can provide different income rights, and there can be multiple tiers of corporate engagement in investments. A corporate tax system addresses this complexity.

For many years, the partnership form typically was employed in uncomplicated circumstances so the pass-through system operated quite well for those organizations. The provision of different tax treatment for partnerships is arbitrary in that it excludes those corporate enterprises that have uncomplicated forms of shareholder ownership and includes partnerships that have complex structures. The adoption of an arbitrary line of distinction is justified as a means of avoiding the administrative chaos that would follow from a rule requiring ad hoc determinations of the degree of an organization's complexity. The prejudice to small corporations is alleviated by the availability of the Subchapter S election.

Currently, the forms of ownership of partnership interests of some large limited partnerships have become as complex as those of many large corporations. The question arises whether such partnerships should be given pass-through treatment. The Treasury addressed this issue in its first Tax Reform proposal (Treasury I) when it proposed to treat a limited partnership with more than 35 partners as a corporation. This proposal was dropped by Treasury when it promulgated its revised version (Treasury II), sometimes referred to as the President's proposal.

The number of persons who own an interest in an organization should not be a factor in its classification. In that regard, the 35 shareholder limit on S corporations should be re-examined. Since the audit process focuses on the organization itself, there is no administrative difficulty in applying pass-through treatment to any number of persons provided that they are identified at the entity level.

Another question is whether the tax treatment of an organization should be determined by criteria that measure the relative difficulty of administering a pass-through system rather than by whether the organization is incorporated. Thus, an uncomplicated ownership form would have pass-through treatment, and a complicated ownership form would have a tax imposed at the entity level. Such a system would be extremely difficult to administer especially since the ownership of an organization can change from time to time and may thereby become more or less complex. The corporate-partnership division is a relatively easy one to administer and may well be preferable, provided that the typical corporation or partnership fits the complex or simple ownership pattern and provided that provision is made for those organizations which do not fall within the expected degree of complexity or simplicity. The Subchapter S election is a good device for dealing with these problems for incorporated organizations. It is elective so that an incorporated organization which does not wish to be subjected to the complexity of the pass-through system (and of the possible involuntary termination of pass-through treatment) need not have it imposed. While the Subchapter S provisions were liberalized in 1982, they might be further expanded.

As to the partnership, the pass-through system should be retained so long as the typical partnership has an uncomplicated ownership structure. As to those partnerships with complex structures, if they impose a significant administrative burden on the Service to apply pass-through treatment, then criteria should be established (by legislative action) to impose corporate tax treatment for such partnerships. But, if this is necessary, the distinction should be based on factors that are easy to ascertain even if the result is an arbitrary line of demarcation. The criteria that are adopted should be aimed at identifying organizations having a complicated form of ownership for which it is difficult to administer a pass-through tax system. For example, tiered partnership ownerships might present such a problem. To date, however, the Service appears able to administer Subchapter K even as to the more complex partnership forms. If so, the pass-through system should be retained for all partnerships, and the restrictions on qualifications for Subchapter S treatment should be re-examined in light of the experience with administering the more complicated forms of partnership structures. ⊠

Douglas A. Kahn is a graduate of the University of North Carolina and of the George Washington University Law School. He practiced in Washington, D.C., and served as a trial attorney with both the Civil and Tax Divisions of the Department of Justice. He has written widely on the subject of federal taxation. Professor Kahn has co-authored two casebooks that are used in tax courses in a number of law schools, and has authored several text books on taxation. He began his academic career at Michigan in 1964 and is now the Paul G. Kauper Professor of Law.