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Taxation of Private Business Firms: Imagining a Future Without Subchapter K

Lawrence Lokken
University of Florida College of Law

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Taxation of Private Business Firms: Imagining a Future Without Subchapter K

*Lawrence Lokken**

* Lawrence Lokken is Hugh F. Culverhouse Eminent Scholar in Taxation and Professor of Law, University of Florida. The author thanks all of those who have read and commented on earlier drafts of this article, including Richard Cohen, Terence Cuff, Mark Gergen, Calvin Johnson, Martin McMahon, and George Yin, some of whom object vigorously to virtually everything said in the article.

I. INTRODUCTION

Subchapter K is a mess. Its history began with the simple idea that a partnership should be treated for income tax purposes as a conduit, obligated to report its income to the IRS and to allocate this income among its partners but not subject to tax itself.[1] Even when subchapter K was enacted in 1954, Congress recognized that the implementation of this simple ideal would not necessarily be simple. Under the 1954 legislation, each partner's distributive share of each item of income, deduction, or credit was usually determined by the partnership agreement, as it might be modified at anytime before the due date of the partnership's return, but if the agreement for the allocation of any item was infected with a principal purpose to avoid tax, the item had to be allocated in the proportions that the partners shared overall taxable income.[2] Although property could generally be contributed to or distributed from a partnership without causing the partnership or any partner to recognize gain,[3] a distribution was treated as a taxable sale, at least in part, if it altered the partner's proportionate interests in unrealized receivables or substantially appreciated inventory.[4]

Subchapter K has been amended repeatedly since 1954. Over the last 25 years, nearly every substantial revenue act has contained significant changes to subchapter K. Although these amendments responded to a variety of emerging problems and issues, one theme underlies a large majority of them: The flexibility of the original conduit model facilitated devices to shift income, deductions, and other tax attributes from partner to partner and from property to property in ways that Congress found unacceptable. The original conception of subchapter K—flexibility with some limitations—has thus become encrusted with more and more limitations.[5]

This congressional activity has been mirrored and magnified in the development of regulations under subchapter K. In 1976, Congress amended the rule on allocations of income, deductions, and credits to deny effect to any allocation agreement that "does not have substantial economic effect."[6] The Treasury responded with regulations interpreting the quoted words that

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1. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954) (subchapter K intended to provide "simplicity, flexibility, and equity as between the partners.").

2. See IRC §§ 704(a), (b), 761(c) (before amendment in 1976).

3. See IRC §§ 721, 731.

4. See IRC § 751(b).

5. See Jeffrey L. Kwall, Taxing Private Enterprise in the New Millennium, 51 Tax Law. 229, 237 (1998) ("Since the early 1980s, a seemingly endless series of legislative fixes have endeavored to forestall tax avoidance at the cost of dramatically complicating Subchapter K.").

6. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(d), 90 Stat. 1520, 1548 (1976).

are prodigiously, even frighteningly complex, and these regulations have required repeated supplementation and amendment, most of which increased their complexity.[7] In 1984, Congress restricted partners' flexibility in allocating income and deductions from property contributed by partners to the partnership.[8] These restrictions were tightened by statutory amendments in 1989 and 1997 and spawned gargantuan regulations, which have also required several amendments.[9] The Treasury has found it necessary to issue detailed regulations under many other provisions of subchapter K, either as enacted in 1954 or as added or amended since 1954, in order to mark the bounds of just what partners can and cannot do with respect to a broad range of partnership transactions.

One of the more striking, and for many the most troubling, of the accumulations of complexity is an anti-abuse rule, adopted by regulation in 1994, which allows the IRS to "recast" a transaction for federal tax purposes if "a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K."[10] This recasting is possible, even if the transaction "fall[s] within the literal words of a particular statutory or regulatory provision."[11] Although the anti-abuse regulation is not complex in the sense of requiring taxpayers to fathom lengthy and dense recitations of rules and exceptions to the rule, its indefiniteness probably causes it to be more complex in application than the most tangled web of verbiage.[12]

The cumulative result of all of this legislative and administrative activity is a system of such complexity that full compliance is only theoretically possible.[13] If partners' contributions are only in cash, partnership distributions consist solely of cash, and each partner has the same

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7. Regs. §§ 1.704-1 (as amended by T.D. 8099, 1986-2 C.B. 84; T.D. 8237, 1989-1 C.B. 180; T.D. 8385, 1992-1 C.B. 199; T.D. 8500, 1994-1 C.B. 183; T.D. 8585, 1995-1 C.B. 120; T.D. 8717, 1997-24 I.R.B. 5), 1.704-2 (1992) (allocations attributable to nonrecourse liabilities).

8. See IRC § 704(c) (before amendment in 1989, 1997).

9. Regs. §§ 1.704-3 (as amended by T.D. 8585, 1995-1 C.B. 120; T.D. 8717, 1997-24 I.R.B. 5; T.D. 8730, 1997-38 I.R.B. 16), 1.704-4 (as amended by T.D. 8717, 1997-24 I.R.B. 5).

10. Regs. § 1.701-2(b).

11. Id.

12. See Kwall, supra note 5, at 238 ("anti-abuse regulations have created unpredictability that exacerbates the complexity").

13. See Curtis J. Berger, W(h)ither Partnership Taxation? 47 Tax L. Rev. 105, 108 (1991) ("In order to keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury [fashioned] a statutory and regulatory apparatus which [is] one of the most inaccessible and burdensome features of the entire tax system.").

proportionate interest in every item of income and deduction, only a few relatively simple provisions of subchapter K apply, and the partnership's accounting is likely to agree with the tax rules, even if the statutes and regulations are never consulted. However, if any one of these conditions is not met, at least one of the highly complicated subgroups of partnership tax rules applies, and, unless the partnership receives and follows tax advice of the highest sophistication, the tax rules are likely violated. In a large number, perhaps a large majority, of such situations, the costs of such advice are prohibitive, given the partnership's size.

Moreover, many tax practitioners believe that very few IRS auditors of partnership returns understand enough of subchapter K to challenge partnership accounting for items subject to the more complicated aspects of subchapter K and that the few auditors with deep understanding of subchapter K are assigned to very large transactions where their skills will likely produce the greatest revenue yield for the government. This perception diminishes taxpayers' incentives to try their best to comply in any but the largest of transactions.

A large number of partnerships thus seem to be governed by what might be called an "intuitive subchapter K." Taxpayers and tax advisers who want to comply account for partnership transactions in ways that are consistent with their conceptions of the basic aims of subchapter K; others account as adventurously as they believe the IRS is likely to tolerate. IRS auditors challenge partnership accounting only if it seems to be seriously out of whack. No one has the ability, resources, and incentive to figure out exactly what the rules require.

If the portrait I have painted of subchapter K is accurate, radical reform is, in my opinion, required. Americans have traditionally prided themselves as being a society of laws. Laws that cannot feasibly be understood and obeyed are the equivalent of no law at all. If laws are enforced only in situations involving very large dollar amounts, ordinary transactions are left in a lawless penumbra.

Professor Yin proposes a solution—a simplified conduit regime for simple private business firms (SPBFs) that elect this regime. It is a creative and useful proposal that deserves careful study. My purpose is to use that proposal as a starting point for a more comprehensive examination of the conduit treatment of business entities.

Professor Yin does an excellent job of describing the problems with conduit treatment generally and subchapter K in particular.[14] His proposal provides a means by which a discrete group of entities could avoid these

14. George K. Yin, The Future Taxation of Private Business Firms, 4 Fla. Tax Rev. 141 (1999).

problems, but it does not solve the problems for entities that either do not qualify for or do not elect SPBF treatment. He urges that a separate effort be made to rationalize subchapter K for these other entities, but he rejects any radical shift away from the basic pass-through model for partnerships not eligible for the simplified conduit regime.[15] My purpose is to examine the path he rejects—to imagine a world largely without subchapter K.

II. The Problem

Although there seems to be broad agreement that complexity in subchapter K is a major problem, less attention has been given to the causes of this complexity. Is the complexity primarily a result of bungling by Congress and the Treasury? Or, is the complexity an inevitable consequence of the conduit ideal when it is utilized in a business and investment culture where tax minimization is seen as a major aspect of profit maximization and where tax authorities believe that ferreting out abuse is a major aspect of their responsibilities? If the former is the case, all that is needed is a redrafting of the Code and regulations. If the latter is the case, alternatives to subchapter K should be considered. Although Congress and the Treasury are not free from blame, the subchapter K mess derives, in my opinion, principally from the ideal, not the execution of the ideal.

It is conventional wisdom that subchapter K has, from its inception in 1954, consisted of an amalgam of aggregate concepts (viewing the partnership as only an aggregation of the separate interests of the partners) and entity concepts (viewing the partnership as an entity separate from its owners). The approach of allocating partnership income among the returns of the partners, rather than taxing the partnership on the income, is an aggregate concept, but even the implementation of that approach has strong entity aspects.

Assume *X* owns an apartment building and *Y* owns an airplane; they agree that (1) *X* will claim depreciation deductions for both the building and the airplane, (2) gain on the eventual sales of both items will be reported by *X* to the extent of the aggregate of the depreciation deductions, and (3) *X* will make a payment to *Y* in the event the price received on sale of the airplane falls short of the property's value when the agreement is made. This agreement is ineffective because depreciation deductions may only be taken by the owner of property, the owner must report all gain on the property's sale, and these items may not be transferred by contract to a taxpayer other than the owner. This principle is so fundamental that returns filed by *X* and *Y* consistently with their agreement would be vulnerable to a charge of fraud.

15. Id.

However, if *X* and *Y* contribute the building and airplane to the *XY* partnership and incorporate their agreement into the partnership agreement, the agreement can be given full effect for tax purposes. After the contributions, the income from the contributed property will be income of an entity (the partnership), and subchapter K gives effect to an allocation of the entity's income among the owners, so long as the allocation has substantial economic effect. The partnership entity thus has a tax consequence not achievable by other means of aggregating the interests of *X* and *Y*.

Similarly, although the rules generally allowing property to be contributed to or distributed from a partnership without recognition of gain or loss have an aggregate flavor, they also reflect an entity conception of the partnership. For example, if *X* swaps an undivided one half interest in her building for an undivided one half interest in *Y*'s airplane, *X* and *Y* both recognize gain on the exchange. However, if *X* and *Y* contribute the building and airplane to the *XY* partnership, neither recognizes gain or loss, even though the effect of the transaction is that *X* exchanges 100% direct ownership of the building for 50% indirect ownership of the building and the airplane. Similarly, if a partnership purchases land and, several years later, distributes the land to one of its partners in liquidation of the partner's interest, generally, gain or loss is not recognized by the partnership or any of the partners as a result of the distribution, even though the distribution exchanges the distributee's indirect interest in the bundle of partnership assets for direct ownership of one of these assets. These exchanges are apparently allowed tax-free because Congress conceived of the partnership as a business and investment entity whose economic usefulness would be diminished by the taxation of gains realized when property enters or leaves the entity.

The entity aspects of subchapter K are the source of the great flexibility of the partnership for tax purposes. By treating a partnership as an entity separate from its partners and a partnership interest as an interest in an entity, not a collection of proportionate interests in partnership assets, the law allows partners to share partnership income, deductions, and property in ways that practically suit their business or investment goals, without unwanted tax consequences springing out of shifts in their claims to partnership property. However, the very same flexibility is also the source of subchapter K's burgeoning complexity because it permits the partners to shift income, deductions, and other tax attributes among the partners in ways that minimize tax obligations with little or no economic cost.

In this writer's opinion, because subchapter K's flexibility and susceptibility to abuse derive from the same source, the balances struck in the statutory scheme are inherently unstable. Uses of the partnership rules that the Treasury finds to be abusive will continue to push the law further into complexity, and this complexity will makes compliance less and less feasible for more and more partnerships.

III. PARTNERSHIP ALLOCATIONS

Section 704(b) denies tax effect to an agreement on the allocation of partnership income, deduction, or credit unless the agreement has "substantial economic effect." The regulations under section 704(b) enforce this rule by requiring that all allocations be reflected in capital accounts and that the capital accounts ultimately determine the partners' entitlements.[16] Under section 704(c)(1)(A), partnership items attributable to property contributed to the partnership by a partner must be allocated "so as to take account of the variation between" the property's basis and fair market value when contributed.

Despite their unworkable complexity, sections 704(b) and (c) and the regulations under those provisions are not effective in weeding out allocations that distort partners' income. The premise of the substantial economic effect test, as worked out in the regulations, is that an allocation of income or deduction to a partner has substantial economic effect if it increases or decreases the partner's ultimate entitlements from the partnership by the amount allocated. However, when allocating items, such as depreciation, which are outside of the partnership's cash flow stream, ascertaining the extent to which the allocation affects a partner's ultimate entitlement is, at best, speculative. The substantial economic effect test thus does not meaningfully restrict tax-motivated shifting when it is applied to tax allowances that with respect to which there are no corresponding economic costs. Also, even if an allocated item is true income or loss of the partnership, an allocation of the item does not necessarily reflect true income or loss of the partner because the allocation rules do not explicitly take into account the time value of money.

A. *A Dollar Is Not Necessarily a Dollar*

Deductions and other tax allowances are often not associated with real economic losses. For example, depreciation deductions are allowed whether or not the depreciable property declines in value. When depreciation exceeds any decline in the property's value, the excess is, at least for the time being, a deduction without cost. An allocation of such a deduction among partners necessarily lacks any true economic consequences, at least in the short run. Where there are special allocations of depreciation with provision for gain chargeback, the regulations indulge in various presumptions in order to reconcile the substantial economic effect requirement with this reality. For example, depreciable property held by a partnership is deemed to decline in

16. See Regs. § 1.704-1(b)(2).

value by the amounts allowed as depreciation, regardless of the property's actual value.[17] Thus, if depreciation on partnership property is allocated to one partner and appropriately reflected in partnership capital accounts, the allocation is deemed to have substantial economic effect, even if the property's value does not decline and the depreciation charge is likely to be recouped through future revenues from the property (e.g., gain on its eventual sale allocated to the partner to whom the depreciation was allocated).

Arguably, partnership allocations of tax items without economic effect should not be a policy concern. These items can artificially reduce tax, regardless of who owns the property or carries on the activity from which the items arise. Because the potential for tax reduction is most attractive to investors who can make best use of the tax allowances, the property or activity tends to be owned by these investors. This being so, perhaps policy makers should not be concerned about which taxpayer claims the item.

Moreover, the kinds of shifts achievable by partnership allocations can be obtained outside the partnership context by the use of debt financing. Assume property worth $851 will produce net revenues (before depreciation) of $100 annually for 20 years, at the end of which time the property will be worthless. The property's yield is 10% (the discount rate at which 20 annual payments of $100 each have a present value of $851). Economic income from the property is $85 for the first year (10% of $851), economic depreciation for the first year is $15 ($100 of net revenues less $85 of income), economic income for the second year is $84 (10% of the excess of $851 over $15), and so forth. But, assume that, due to generous depreciation allowances (straight line depreciation), taxable income from the property is projected to be $57 annually (before financing costs) throughout the 20-year period. *X* purchases the property for $851, paying $713 of the price with a 20-year, 8% loan from *L*. For the first year, the deduction for interest on the loan is $57 (8% of $713), which equals the taxable income before interest costs. For that year, *X* thus has economic income of $28 ($85 less $57) and taxable income of zero. Of the two persons having an investment in the property, *L* (the lender) reports the $57 of taxable income from the property, and *X* (the title holder) enjoys the $28 of economic income that is not taxed. The results would be the same if *L* and *X* instead formed a partnership to hold the property, with *L* being allocated partnership taxable income each year equal to 8% of its capital account and *X* being allocated the remaining income and with the partnership's annual cash flow being distributable in the

17. See Regs. § 1.704-1(b)(2)(iii)(*c*) (In determining substantiality of allocation's economic effect, fair market value of partnership property is presumed to equal adjusted basis, and "adjustments to the adjusted tax basis [are] presumed to be matched by corresponding changes in such property's fair market value.").

proportions $73 to *L* and $27 to *X*. The comparisons are worked out more fully in Example 1.

Example 1
***X* Owns Property Worth $851**
Generating Annual Net Revenue of $100

Year	*Net Revenue*	*Depreciation* *Economic*	*Depreciation* *Tax*	*Net Income* *Economic*	*Net Income* *Tax*	*Difference*
1	$100	$15	$43	$85	$57	$28
2	100	16	43	84	57	27
3	100	18	43	82	57	25
4	100	20	43	80	57	23
5	100	22	43	78	57	21
10	100	39	43	61	57	4
16	100	62	43	38	57	(19)
17	100	68	43	32	57	(25)
18	100	75	43	25	57	(32)
19	100	83	43	17	57	(40)
20	100	91	43	9	57	(48)

***X* Finances Property**
with 8% $713 Loan

Year	*Net Revenue*	*Interest*	*Depreciation* *Economic*	*Depreciation* *Tax*	*Net Income* *Economic*	*Net Income* *Tax*	*Difference*
1	$100	$57	$15	$43	$28	-0-	$28
2	100	56	16	43	28	1	27
3	100	54	18	43	28	3	25
4	100	53	20	43	27	4	23
5	100	51	22	43	27	6	21
10	100	41	39	43	20	16	4
16	100	23	62	43	15	34	(19)
17	100	19	68	43	13	38	(25)
18	100	15	75	43	10	42	(32)
19	100	10	83	43	7	47	(40)
20	100	5	91	43	4	52	(48)

X and L are Partners

	Partnership Income		Tax Allocations	
Year	Economic	Tax	L	X
1	$85	$57	$57	-0-
2	84	57	56	1
3	82	57	54	3
4	80	57	53	4
5	78	57	51	6
10	61	57	41	16
16	38	57	23	34
17	32	57	19	38
18	25	57	15	42
19	17	57	10	47
20	9	57	5	52

To be sure, there are important financial differences between a lender's interest and a partnership interest. However, the point of the example is that, when taxable income diverges from economic income, the benefit or detriment of the divergence can be allocated between a lender and an equity investor in the same way in which the subchapter K rules allow it to be allocated among partners.

Nevertheless, partnership allocations have unique features that allow tax benefits to be shifted from partner to partner in ways not possible in other contexts. For example, partnership allocations may be altered from year to year. Under sections 704(a) and 761(c), each item of partnership income, deduction, and credit is usually allocated among the partners as provided in the partnership agreement, as it may be amended at any time before the partnership's return is due. No partner recognizes gain or loss as a result of an amendment of the partnership agreement, even if the amendment substantially changes the nature of each partner's interest. The allocation of tax benefits from multiparty investments organized in other ways generally flows from the structure in which the investment is originally cast, and a change in this allocation may cause each participant to be taxed as though she had exchanged one interest in the underlying property for another.[18] For example, if *X* purchases the property in Example 1, financing the purchase with a loan from *L*, *X* and *L* cannot trade places without recognizing gain or loss, but if they organize the *XL* partnership to acquire and hold the property,

18. For example, a substantial modification of a debt instrument is treated as an exchange, often taxable, of one debt instrument for another. See Regs. § 1.1001-3.

the allocation of the tax benefits of ownership can be altered year-by-year so long as the substantial economic effect test is met.

The partnership allocation mechanism also is more flexible in not confining the sorting to broad categories, such as debt and equity. This allows partners to fashion their arrangements to direct each tax benefit in the way that best minimizes their tax liabilities.

B. *A Dollar Is a Dollar, Not Gross Income or Deduction*

Partnership allocations that have substantial economic effect do not necessarily reflect the partners' economic income. For example, tax laws sometimes attach characterizations to income or deduction items that have important tax consequences but do not have economic consequences. Apart from taxes, partners are concerned only about the number of dollars allocated to them, but a partner's tax liabilities can be importantly affected by whether a particular allocation consists, for example, of capital gains or ordinary income or, in the case of a capital gains allocation, whether the allocated item is long- or short-term gain. Under the regulations, capital gains can validly be allocated to one partner and ordinary income to another if there is a strong likelihood that the dollar amounts of the partnership allocations will be affected by the sorting method prescribed by the partnership agreement, even if the economic effects of the allocation may be neutralized by the tax effects of the ordinary income/capital gains characterizations.[19]

Partnership allocations can also alter the timing of partners' income in ways not achievable in other contexts and sometimes in ways that contradict the policies that apply in other contexts. This point is developed in several examples below.

Example 2A. *X* purchases for $685 the right to all interest on a $1,000, 8% 15-year bond, and *Y* purchases for $315 the right to the principal payment at maturity. Under section 1286, *X* and *Y* must each accrue interest income annually at 8% on their unrecovered investments. For the first year, the accruals are $55 for *X* and $25 for *Y*; for the second, they are $53 for *X* (8% of excess of $685 over capital recovery of $25 for year 1) and $27 for *Y*. Over the bond's 15-year term, *X* has interest income of $515, and *Y* has interest income of $685.

19. See Regs. § 1.704-1(b)(5) ex. 7(iii). But see Regs. § 1.704-1(b)(2)(iii)(a), under which, after factoring in the after-tax consequences, the allocation may be found to be not substantial.

Example 2A
X and *Y* Strip a $1,000, 8%, 15-Year Bond

	X		*Y*	
Year	*Cash Flow*	*Income*	*Cash Flow*	*Income*
1	$80	$55	-0-	$25
2	80	53	-0-	27
3	80	51	-0-	29
4	80	48	-0-	32
5	80	45	-0-	35
6	80	43	-0-	37
7	80	40	-0-	40
8	80	37	-0-	43
9	80	33	-0-	47
10	80	30	-0-	50
11	80	26	-0-	54
12	80	21	-0-	59
13	80	16	-0-	64
14	80	11	-0-	69
15	80	6	$1,000	74

Example 2B. *X* and *Y* instead form a partnership to acquire and manage a portfolio of debt instruments. *X* and *Y* contribute $685 and $315, respectively, to the partnership. Partnership income (expected to be $80 annually) is allocated 99% to *X* and 1% to *Y*, this income is distributable annually in the same proportions, and on liquidation, which the partnership agreement requires to occur 15 years after the partnership is organized, partnership assets (expected to be worth $1,000) are distributable 1% to *X* and 99% to *Y*.

Example 2B
***XY* Investment Partnership**

	X		*Y*	
Year	*Distribution*	*Income*	*Distribution*	*Income*
1	$79.2	$79.2	$0.8	$0.8
2	79.2	79.2	0.8	0.8
3	79.2	79.2	0.8	0.8
4	79.2	79.2	0.8	0.8
5	79.2	79.2	0.8	0.8
6	79.2	79.2	0.8	0.8
7	79.2	79.2	0.8	0.8
8	79.2	79.2	0.8	0.8
9	79.2	79.2	0.8	0.8
10	79.2	79.2	0.8	0.8
11	79.2	79.2	0.8	0.8
12	79.2	79.2	0.8	0.8
13	79.2	79.2	0.8	0.8
14	79.2	79.2	0.8	0.8
15	79.2	79.2	0.8	0.8
Liquidation	10	($675)	$990	$675

The allocation agreement, by assigning almost all of the interest income to *X*, contradicts the principle of section 1286—that interest income should accrue at a constant rate to all persons owning segments of a stream of payments represented by a debt instrument. The income allocations are also not permissible under section 704(b). Allocations have substantial economic effect only if they are reflected in capital accounts and, among other things, each partner is entitled to distribution of the balance of the partner's capital account.[20] Since *X* and *Y* receive income allocations equal to the distributions to them, their capital accounts remain unchanged at $685 and $315 throughout the partnership's existence, and the distribution on liquidation can be made in accordance with the agreement ($10 to *X* and $990 to *Y*) only by ignoring the capital accounts. Instead of the allocations prescribed in the partnership agreement, the *XY* partnership's income must be allocated according to the underlying economic arrangement between the partners with reference to the partnership's income items.[21]

Example 2B illustrates how the substantial economic effect test, by requiring that allocations be reflected in capital accounts and that the capital

20. See Regs. §§ 1.704-1(b)(2)(ii)(*b*), (iv).
21. See Regs. § 1.704-1(b)(3)(i).

accounts determine the partners' financial entitlements, imposes significant restraint on the extent to which partnership allocations can be used to upset timing requirements that apply to other investment structures. However, as shown by subsequent examples, the capital account rules do allow significant departures from those timing requirements.

Example 2C. The *XY* partnership agreement instead requires partnership taxable income for each year to be allocated in proportion to the partners' capital accounts at the beginning of the year. The income is distributable annually 99% to *X* and 1% to *Y*, as in Example 2B, but the liquidating distribution is in proportion to the partners' capital accounts. Since the results are fully consistent with those prescribed by section 1286 for Example 2A, it is appropriate that the allocations be considered to have substantial economic effect.

Example 2C
***XY* Investment Partnership**

	X		*Y*	
Year	*Distribution*	*Income*	*Distribution*	*Income*
1	$79.2	$55	$0.8	$25
2	79.2	53	0.8	27
3	79.2	51	0.8	29
4	79.2	48	0.8	32
5	79.2	45	0.8	35
6	79.2	43	0.8	37
7	79.2	40	0.8	40
8	79.2	37	0.8	43
9	79.2	33	0.8	47
10	79.2	30	0.8	50
11	79.2	26	0.8	54
12	79.2	21	0.8	59
13	79.2	16	0.8	64
14	79.2	11	0.8	69
15	79.2	6	0.8	74
Liquidation	10	-0-	$990	-0-

Example 2D. Under the *XY* agreement, (1) partnership taxable income is allocated 80% to *X* and 20% to *Y* for the first seven years of the partnership's 15-year term and solely to *Y* during the last eight years, (2) annual net income is distributable 99% to *X* and 1% to *Y* (as in Example 2C), and (3) the liquidating distributions will equal the partners' capital accounts. The financial results are nearly the same as in Examples 2B and 2C. For *X*, yearly excesses of distributions over income allocations reduce her capital account from $685 to $9, and *Y*'s capital account increases from $315 to $991 through yearly excesses of income allocations over distributions.

Example 2D
***XY* Investment Partnership**

	X		*Y*	
Year	*Distribution*	*Income*	*Distribution*	*Income*
1	$79.2	$64	$0.8	$16
2	79.2	64	0.8	16
3	79.2	64	0.8	16
4	79.2	64	0.8	16
5	79.2	64	0.8	16
6	79.2	64	0.8	16
7	79.2	64	0.8	16
8	79.2	64	0.8	16
9	79.2	-0-	0.8	80
10	79.2	-0-	0.8	80
11	79.2	-0-	0.8	80
12	79.2	-0-	0.8	80
13	79.2	-0-	0.8	80
14	79.2	-0-	0.8	80
15	79.2	-0-	0.8	80
Liquidation	9	-0-	$991	-0-

As compared with Example 2C, *X*'s income is accelerated and *Y*'s income is deferred. Under the regulations, an allocation lacks substantial economic effect if it is possible that the allocation may be offset by a subsequent allocation and, when the allocation is agreed upon, "there is a strong likelihood" that (1) the ultimate effects on the partners' capital accounts "will not differ substantially from" the capital account increases and decreases that would occur if the partnership agreement provided for neither the original nor the offsetting allocation and (2) the original and offsetting allocations will reduce the partners' "total tax liability."[22] The initially greater allocations to *X* are ultimately offset by smaller allocations near the end of the partnership's life, and the opposite happens for *Y*. By the end of the partnership's 15-year life, the offsets will be complete and the capital accounts will be virtually identical to those in Example 2C.

However, notwithstanding the possibility of offset, an allocation is deemed to substantially affect ultimate entitlements if "there is a strong

22. Regs. § 1.704-1(b)(2)(iii)(c).

likelihood" that any offsetting allocation will occur more than five years after the initial allocation.[23] In Example 2D, if offsetting allocations are determined by comparing them with Example 2C, the allocations for the first four years have substantial economic effect because the offsets occur more than five years later. Although the offsets to the allocations for the fifth year through the eighth year occur in part within five years and thus are probably invalidated by the transitory allocation rule, the regulations allow a significant temporal shifting between *X* and *Y*.

Arguably, the results in Example 2D are not inappropriate because they follow from the sharp distinction drawn in present law between debt and equity. Although Congress and the Treasury have labored over the years to tax returns from debt instruments on an accrual basis, equity investors are offered many opportunities to defer tax on investment returns. For example, *Y* might purchase land with a timber stand expected to be cut in 10 years, or she might purchase and hold for 10 years stock of a corporation whose policy is to reinvest all earnings in expansion of its businesses. Arguably, because being a partner is an equity investment, *Y* should also be allowed to defer tax on investment returns through a partnership investment.

However, the partnership situation is unique. Wealth accruing to the owner of a stand of trees is not taxed until the trees are cut, regardless of who the owner is. When a corporation retains all of its earnings, it is taxed on these earnings, even though the shareholders are not. If the corporation accrues untaxed wealth (e.g., by building goodwill or developing valuable intellectual property), it escapes tax through principles that apply regardless of who the owner is.

In contrast, partnership allocations can be structured to defer tax by shifting currently taxable income to other participants. *Y*'s tax deferral in Example 2D results from the structure in which the investment is held, not from the type of property comprising the investment. As shown by Example 2D, partnership allocations can be used to alter timing mechanisms carefully crafted by Congress.

Although Example 2 deals with debt securities, the point made is not limited to partnerships whose principal assets are debt instruments. The example is intended to demonstrate how, even when tax rules applicable to the underlying assets are economically realistic (as is generally so for debt instruments), partnership allocations can be used to divorce tax consequences from economic consequences. In a partnership with other types of assets (e.g., a leasing partnership), partnership allocations may exhibit both the effects demonstrated in Example 1 (shifting of tax preferences from partner to

23. See id. Offsets are "determined on a first-in, first-out basis." Id. Regs. § 1.704-1(b)(2)(iii)(*c*)(2).

partner) and those shown in Example 2 (shifting of economic income from partner to partner).

C. *Alternatives; Allocations in Proportion to Capital*

In this writer's opinion, the flaws in the present allocation rules are not merely flaws in the execution of the simple idea of conduit taxation that underlies subchapter K. Rather, the flaws expose a fundamental problem with conduit taxation: When an entity's owners share income in complex ways, there is often no feasible means of determining at the end of each year how the entity's income or loss for the year is economically shared by the owners. The owners commonly conceive of their sharing arrangements as they will apply over a period of several years. Annual allocations of income and loss, as the tax laws require, may therefore be wholly artificial. Any effort to match these allocations with the owners' long-run expectation is bound to be complicated, artificial, or both.[24]

For example, the problems discussed above might be addressed by amending section 704(b) to require that each item of partnership income, deduction, and credit be allocated in proportion to the partners' interests in partnership capital. In Example 2, this approach would require that allocations be made as in variation 2C, which is fully consistent with the principle of section 1286.

One objection to this approach is that, in many situations, it would put partners in a tighter straitjacket than investors making similar investments in other contexts. For instance, in the partnership variation of Example 1, where *X* and *L* invest $138 and $713, respectively, in a real estate partnership, a requirement that allocations be in proportion to income would require that taxable income for the first year be allocated 83.8% ($713/$851) to *L* and 16.2% to *X*, even though the partnership allocation agreement (to *L* to the extent of 8% of its capital account, remainder to *X*) is consistent with the results of a debt-financed investment outside the partnership context.

Also, this approach would be awkward as applied to partnerships in which some partners contribute services and other partners contribute money or other property. Assume *X* and *Y* form a partnership to develop and market experimental electronic devices.[25] *X* contributes $2,500 in cash and agrees

24. See Kwall, supra note 5, at 243-44. Subchapter K permits allocations that are not proportionate to owners' interests and allows allocation proportions to change from year to year. See id. at 243. The resulting "burden fall[ing] on the tax law to identify the economic relations of the owners . . . inevitably is quite complicated and creates potential for abuse." Id. Trying to "perfect[] such a system is probably futile because the abuse potential may ultimately be impossible to eliminate." Id. at 244.

25. See Regs. § 1.704-1(b)(5), ex. 3.

to work full-time in the partnership's business; *Y* contributes $100,000 in cash and is not expected to participate actively in the business. Under the partnership agreement, deductions for research and development costs are allocated to *Y*, and partnership income and loss, exclusive of these costs, is allocated 99% to *Y* and 1% to *X* until the income allocations to *Y* have fully recouped the R&D and loss allocations to *Y*; thereafter, *X* and *Y* will share partnership income and loss equally. A proportionate-to-capital approach would require that all items of gross income and deduction be allocated in the proportions $2,500 to $100,000, approximately 2% to *X* and 98% to *Y*. The results are not radically different from the partners' agreement on the allocation of R&D costs and start-up losses, but *X* is prevented from sharing more than minimally in partnership taxable income after these costs and losses have been made up.

Assume the *XY* partnership expends all of the capital contributions in research and development during year 1, but thereafter has taxable income of $102,500 annually. The allocations for year 2 restore the partners' capital accounts to $2,500 and $100,000, more or less consistently with the partners' agreement. However, for year 3 and later years, partnership income is split $2,500 to *X* and $100,000 to *Y*, even though the partners have agreed to share this income equally. If the partnership makes significant distributions of income allocated under the partnership agreement, *X's* capital account will quickly go into deficit, thereby ending all allocations of taxable income to *X*. Over time, *Y* would be taxed on huge amounts that are distributable to *X* under the partnership agreement.

The problem in this case is that *X*'s principal contribution to the partnership, her services, is not recognized in the allocations. Arguably, this problem could be overcome by treating profit shares based on contributions of services much as guaranteed payments are treated under present law—that is, by taxing services partners on their profit shares and allowing these shares as deductions in computing the partnership taxable income to be allocated in proportion to capital. However, as the example illustrates, this approach is not very satisfactory if a services partner also contributes capital and the partnership agreement does not segregate profit shares for, respectively, the services and the capital contributions. If *X*'s 50% share of profits were treated as a guaranteed payment, the remaining 50% of partnership profits would be shared 25 of 1,025 by *X* and 1,000 of 1,025 by *Y*, yielding results close to those of the partnership agreement only because *X*'s capital contribution is very small in relation to *Y*'s.

This approach would also do a relatively poor job of reflecting the partners' interests where the partners do not share investment risks in proportion to capital contributions, as developed below in Example 3.

Example 3. The *XY* partnership purchases undeveloped land for $10,000. *Y* invests in the partnership primarily for the opportunity to share in appreciation in the property's value, while *X* is primarily interested in the more certain, but relatively small return that will be earned by leasing the land for agricultural use (expected to be $80 annually). *X* contributes $1,000 to the partnership, and *Y* contributes $9,000. Partnership profits and losses from rental of the land are allocable 99% to *X* and 1% to *Y*, and profits and losses on the land's sale, which may not occur sooner than 10 years after the partnership's organization, are allocable 1% to *X* and 99% to *Y*. All allocations are to be recorded in the partners' capital accounts, profits are to be distributed as realized in the proportions allocated to the partners, and the partnership is to be liquidated immediately after the land's sale by distributing to each partner the balance in her capital account. If the partnership sells the land on the first day of the eleventh year for $15,000, recognizing gain of $5,000, the results are as given in Example 3A.

Example 3A
***XY* Land Partnership**
Allocations Under Regulations

	X			*Y*		
Year	*Income*	*Distrib.*	*Cap. Act.*	*Income*	*Distrib.*	*Cap. Act.*
1	$79.2	$79.2	$1,000	0.8	0.8	$9,000
2	79.2	79.2	1,000	0.8	0.8	9,000
3	79.2	79.2	1,000	0.8	0.8	9,000
4	79.2	79.2	1,000	0.8	0.8	9,000
5	79.2	79.2	1,000	0.8	0.8	9,000
6	79.2	79.2	1,000	0.8	0.8	9,000
7	79.2	79.2	1,000	0.8	0.8	9,000
8	79.2	79.2	1,000	0.8	0.8	9,000
9	79.2	79.2	1,000	0.8	0.8	9,000
10	79.2	79.2	1,000	0.8	0.8	9,000
11	50	1,050	-0-	4,950	13,950	-0-

If the capital accounts are maintained as the regulations require, the allocations in Example 3 have substantial economic effect because each partner will receive distribution of each dollar of income allocated to her and will experience a reduction in the distribution on liquidation for each dollar of loss allocated to her.

If partnership allocations were required to be proportional to capital, all profits and losses would be allocated 10% to *X* and 90% to *Y*. For example, if the partnership has net rental income of $80 annually for 10 years and then sells the land for $15,000, the allocations of each year's rental profits would be as in Example 3B.

Example 3B
***XY* Land Partnership**
Allocations in Proportion to Capital

	X			*Y*		
Year	*Income*	*Distrib.*	*Cap. Act.*	*Income*	*Distrib.*	*Cap. Act.*
1	$8.0	$79.2	$928.8	$72.0	0.8	$9,071.2
2	7.4	79.2	857.0	72.8	0.8	9,143.0
3	6.9	79.2	784.7	73.1	0.8	9,215.3
4	6.3	79.2	711.8	73.7	0.8	9,288.2
5	5.7	79.2	638.3	74.3	0.8	9,361.7
6	5.1	79.2	564.2	74.9	0.8	9,435.8
7	4.5	79.2	489.5	75.5	0.8	9,510.5
8	3.9	79.2	414.2	76.1	0.8	9,585.8
9	3.3	79.2	338.3	76.7	0.8	9,661.7
10	2.7	79.2	261.8	77.3	0.8	9,738.2
11	130.9	1,050	(657.3)	4,869.1	13,950	657.3

Presumably, *X* would recognize gain on liquidation equal to the negative balance in her capital account after the liquidating distribution, and *Y* would recognize an equal loss. However, this gain and loss are merely corrections to the cumulative errors that the proportional-to-capital rule would create by allocating partnership income differently from the basis on which the partners agreed to share it. Moreover, as Example 3B shows, the rule would make the tax allocations much more complicated than they are if the partnership agreement is followed, as it is in Example 3A. Although the rule is simple to state, it thus exacerbates a principal problem of the present subchapter K: complexity.

In this particular case, the regulations provide a more realistic treatment. *X* invests $1,000, essentially for rights to three items: $79.2 annually for 10 years; the return of the $1,000 at the end of that period; and 1% of any gain or loss on the property's sale. Since the latter right is too contingent to warrant any recognition of gain or loss on it before the sale, it is reasonable to tax *X* on the annual payments and reckon up any gain or loss at the end. The regulations so provide.

However, any generalization that might be made from this case is likely to be contradicted by the results in similar cases. Example 3 shows the inadequacy of a rule requiring allocations in proportion to capital. It does not prove the adequacy of the substantial economic effect test of section 704(b) and the regulations thereunder.

The fundamental objection to a requirement of allocations in proportion to capital is that it often causes income clearly belonging to one partner to be taxed to another partner. When the partners' contributions include services as well as financial capital and when partners agree to share different income streams differently, allocations in proportion to capital may not correspond to the partners' economic income from their partnership investments.

This objection should be recognized by those protective of the fisc as well as by taxpayer advocates. Any tax rule that departs from economic reality is a double-edged sword. For taxpayers who overlook the rule in their planning, the rule can defeat reasonable expectations about the tax consequences of their investments. For taxpayers who fully understand the rule's operation, it is a useful tool for manipulation.

IV. CONTRIBUTIONS AND DISTRIBUTIONS

Generally, property can be contributed to and distributed from a partnership without recognition of gain or loss by the contributing or distributee partner or by the partnership. In a wholly unrestricted form (as generally existed when subchapter K was enacted in 1954), this approach allows gains and losses inherent in property other than money to be shifted freely to one or more partners. Appreciation or depreciation in property owned by one partner can, by contribution to the partnership, be made potential gain or loss to be shared in the partnership collective, and appreciation or depreciation in partnership property can, by distribution, be made potential gain or loss of one partner, the distributee.

Over the last 25 years, Congress has steadily restricted these shifting opportunities. Section 704(c)(1)(A)—under which gain or loss on a partnership's sale of property contributed to the partnership is, to the extent of appreciation or depreciation accrued at the time of contribution, allocated solely to the contributing partner—was initially elective, but in 1984 it became mandatory.[26] As originally enacted, the mandatory version of section 704(c)(1)(A) was circumvented if contributed property was distributed to a partner other than the contributing partner or if the contributing partner received a liquidating distribution of property other than the contributed property before gain or loss was recognized on the contributed property. The distribution loophole was closed in 1989, and the prerecognition-exit loophole was closed in 1992.[27]

The history of section 704(c)(1)(A) has been repeated in several other contexts involving partnership distributions. Congress perceives loopholes and legislates to close them, but the legislation and the often lengthy regulations needed to implement the legislation expose other shifting opportunities,

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26. See Act effective March 31, 1984, §71(a), Pub. L. No. 98-369, 26 U.S.C. 704.
27. See IRC §§ 704(c)(1)(B), 737.

requiring further legislation and regulations to close down these possibilities. As with partnership allocations, the accumulated complexity is difficult to comply with, even by taxpayers wanting to comply, and provides cover for even modestly clever efforts to evade the rules.

Most of these shifting opportunities could be foreclosed by requiring partners to recognize gain or loss on all contributions to partnerships and by requiring partnerships to recognize gain or loss on all distributions. A gain recognition rule could be easily understood by taxpayers, and although it would require valuation of all contributed and distributed property, it surely would be less difficult to administer than the present rules.

Requiring recognition on all contributions might be seen as erecting an unwise impediment to business formations. It has traditionally been possible to organize a business entity tax-free whether the entity is a corporation, partnership, or other form of organization. Under section 351, a transfer of property to a corporation in exchange for stock is a nonrecognition transaction for the transferor only if the transferor (together with others making contemporaneous transfers) holds at least 80% of the corporation's stock immediately after the transaction. Section 721 is more liberal, allowing nonrecognition on a transfer to a partnership in exchange for a partnership interest, regardless of the transferor's proportionate interest. Given its long history and role in facilitating business formations, the principle of tax-free formation should not be abandoned for partnerships, at least so long as it continues to reign in the corporate context.

However, under sections 311 and 336, a corporation distributing property to its shareholders must recognize gain (and sometimes loss) as though it had sold the property to the distributees. This principle applies to S corporations, as well as C corporations, establishing a history of gain recognition on distributions by pass-through entities. Congress and the Treasury have repeatedly found it necessary to add layers of complexity to stop abuses involving partnership distributions. Requiring recognition on distribution is probably less disruptive of legitimate business operations than would be recognition on contribution. Recognition on distribution would obviate the need for much complexity and be a more effective guard against manipulation than the present patchwork of permissiveness and complex limitation.

V. A Radical Solution

Subchapter K suffers from two fundamental flaws: It is so complicated that many partnerships cannot reasonably be expected to comply with its rules, and even when these complex rules are fully obeyed, the tax results do not necessarily reflect the economic realities of the partners' investments.

The most pervasive and consequential of these problems is probably complexity. It could be addressed by returning to a regime much closer to the subchapter K of 1954. For example, the complexity of the allocation regulations could be alleviated by a much simpler statement of the capital account procedures. The primary goal in this simplified restatement would be to ensure that allocations have economic effect, and the substantiality of the allocations' economic effects would be considered only to the extent that substantiality constraints can be simply stated and easily applied. The rules on shifting tax consequences and transitory allocations would probably disappear.

However, this approach would aggravate misallocation problems, and for more than 20 years, successive Congresses have found unacceptable the potentials for abuse arising from unrestrained flexibility. Turning back the clock seems not to be a viable option.

The problems of complexity and misallocation under present law could be resolved with a radically different model of pass-through taxation. Under this model, subchapters K, S, and C would persist, more or less as under present law, but the allocation of business and investment firms between these regimes would be changed. In light of two signal events in the history of entity classification—widespread adoption of limited liability company (LLC) laws and the Treasury's promulgation of the check-the-box regulations—it no longer makes sense to classify entities for income tax purposes with reference to their state-law characterizations or characteristics. Whether a business entity is organized as a partnership, limited liability company, corporation, or in some other form should not affect federal tax liabilities. Instead, income tax classifications should depend on factors peculiarly relevant to the income tax laws.

The model proposed here retains subchapters K, S, and C, but it significantly readjusts the sorting of entities between the three categories, and it also makes changes in the rules applicable to entities within each category. Subchapter K would be closed to all firms other than service firms. Nonservice firms could only qualify for one conduit regime, a revised subchapter S that would encompass partnerships and limited liability companies, as well as corporations, exhibiting the simple ownership structure historically required of S corporations. Subchapter C would also be broadened to include all business entities, regardless of form of organization, other than those subject to the revised subchapters K and S. However, subchapter C entities would be divided into two groups, those having at least one publicly-traded equity interest and those having no such interest. The former group would continue to be subject to the classical, double-tax regime now applicable to all C corporations. The latter group—private, nonconduit entities—would be taxed at the highest individual rate of tax on taxable income computed without any deduction for interest expense. The holders of equity interests and debt instruments issued by private, nonconduit entities would not be taxed on distributions (including interest), except that a complete or partial liquidation of an equity interest or retirement of debt would be treated as a sale of the retired interest.

In the ensuing discussion of this model, frequent reference is made to a very similar model recently proposed by Professor Jeffrey L. Kwall.[28]

A. *Subchapter K*

Under the proposed model, the highly flexible pass-through regime embodied in subchapter K would only be available for services firms with two or more owners for which capital is not a material income-producing factor.[29] The significant misallocation possibilities, and nearly all of the complexity that has arisen to limit these possibilities, relate to income from capital. For services firms with relatively little capital, the objective of section 704(b)—that the partners taxed on partnership income should actually receive it in the end—can only be attained through the basics of the capital account mechanisms of the present regulations. So long as these mechanisms operate, no significant distortions can result from allowing partners the right to adjust allocations annually, as late as the due date of the partnership's return.

An entity for which capital is not a material income-producing factor would be subject to subchapter K regardless of how it was organized. However, the entity would not be allowed to elect to be subject to subchapter S if it meets the eligibility requirements discussed below, and it could also elect to be a C entity.[30]

B. *Subchapter S*

1. *Eligibility.*—Subchapter S would be revised to apply to any business entity for which capital is a material income-producing factor, regardless of the entity's form of organization, if (1) the entity has only one class of equity interests, (2) none of these interests is publicly traded, (3)

28. Kwall, supra note 5.

29. The issue of whether capital is a material income-producing factor in a business existed for several decades under § 911 (partial exclusion of earned income from foreign sources). IRC § 911(d)(2)(B). Over the years, the concept has also been used in a few other contexts. For a discussion of the case law on the issue, see Michael Asimow, Section 1348: The Death of Mickey Mouse? 58 Cal. L. Rev. 801, 836-42 (1970).

A services firm with only one owner would be disregarded for tax purposes, regardless of its form of organization. See infra note 32 and accompanying text.

30. For the appropriateness of allowing these elections, see Yin, supra note 14; see also infra text accompanying note 40.

equity interests are held by more than one person and not more than 100 persons, and (4) the entity does not elect to be a C entity.[31] The one class requirement would be met only if each equity interest entitles its owner to the same proportion of every item of the entity's gross income, deductions, and credits for all years of the entity's existence, except that this proportion would have to change to reflect appropriately the issuance of additional ownership interests, capital contributions, and partial and complete retirements of equity interests. An entity with only one equity-interest holder would be disregarded for U.S. income tax purposes, essentially treated as a sole proprietorship.[32]

Several classes of shareholders ineligible under the present subchapter S could be S equity holders under this model. Other business entities could be equity holders whether their tax regimes are subchapter C, K, or S. For example, a C entity with publicly traded equity interests could hold an equity interest in an S entity. Trusts and estates could also hold S equity interests.

Professor Kwall's simple conduit regime would be closed to an entity having a foreign person among its equity owners.[33] His reason for this condition is persuasive. Since tax cannot feasibly be collected from foreign persons not directly engaged in business in the United States, tax on their U.S. incomes is usually collected by withholding.[34] Professor Kwall worries that a withholding tax collected from the entity could complicate administration of the one class requirement.[35] If the entity does not distribute its income currently but is required to pay withholding taxes on the income shares of foreign owners, the proportionate interests of foreign and domestic owners are not fully equivalent since no similar cash disbursement is made on behalf of the domestic owners.[36]

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31. In one situation, a qualifying entity should be an S entity only if it affirmatively elects to be such. If an entity initially does not qualify to be an S entity (because it has more than one class of equity interests, publicly traded equity interests, or more than 100 equity owners) but later qualifies (e.g., by redemptions that eliminate a second class of interests or publicly traded interests or reduce the number of interest holders to 100 or fewer), the entity should not be an S entity unless it so elects.

32. Under present law, a one-owner limited liability company electing conduit treatment is so classified as a "tax nothing," but a corporation with one shareholder can be an S corporation. Temp. Regs. § 301.7701-3(a). Consistent with the general goal in this model to avoid distinctions dependent on form of organization, either the tax-nothing approach or the S approach should apply to all entities. The tax-nothing approach is chosen because it is probably simpler and less susceptible to manipulation.

33. See Kwall, supra note 5, at 252-53.

34. See IRC §§ 1441, 1442 (withholding tax from foreign persons' nonbusiness incomes), 1446 (withholding tax from foreign partners' distributive shares of partnership taxable income effectively connected with U.S. business).

35. See Kwall, supra note 5, at 252-53.

36. Id.

However, the effect of Professor Kwall's limitation is that conduit taxation would be wholly unavailable to an entity if just one of its owners were foreign, even if this person's proportionate interest were only a fraction of 1%. Presently, a corporation with a foreign shareholder cannot be an S corporation,[37] but subchapter K applies to a partnership, regardless of foreign ownership. Denying all possibility of conduit taxation to all entities with foreign ownership seems extreme.

Perhaps, a more reasonable limitation is to allow an entity with a foreign owner to be an S entity only if the documents defining the owners' rights require withholding taxes paid on behalf of any owner to be accounted for as loans, repayable with interest from distributions to the owner if not previously repaid. To limit manipulation, the interest rate for any year might be required to be not less than the short-term applicable federal rate (AFR) for the first month of the year and not more than twice that rate.

Under the model proposed here, conduit treatment would not be available to an entity with more than 100 equity holders, even if none of the entity's equity interests is publicly traded.[38] The principal reason for this limitation is administrative: Coordinating entity-level determinations of income with owner-level reporting of these items gets more complicated, and as the number of owners increases, the possibilities of coordination errors grow. In recently creating an elective simplified flow-through mechanism for partnerships with 100 or more partners, Congress recognized that "relatively small, passive interests in large partnerships [are i]n many respects . . . indistinguishable from . . . corporate stock."[39]

Professor Yin argues that an entity qualifying for conduit treatment should not be allowed to elect against this treatment because, whenever conduit treatment would tax the owners on their economic shares of entity income at their personal tax rates, the election could be made to substitute a wrong rate for the right rate.[40] This position makes sense in the context of his model, which treats all private business firms as conduits. However, under the model proposed here firms would not be precluded from opting C status. Since conduit taxation is open only to firms meeting restrictive conditions, a firm not wanting conduit taxation could effectively elect C status by failing one of the conditions in a way that does not substantially alter the owners' interests (e.g., by issuing a small preferred equity interest). Moreover, because

37. See IRC § 1361(b)(1)(C).

38. Under present law, a corporation with more than 75 shareholders may not be an S corporation. See IRC § 1361(b)(1)(A).

39. Staff of Joint Comm. on Tax'n, 105th Cong., General Explanation of Tax Legislation Enacted in 1997 354 (Comm. Print 1997).

40. See Yin, supra note 14, at 149-50.

private C entities are taxed at the highest individual rate, an election of C status would not often have the effect of reducing tax obligations.

2. *Fixed Payment Instruments.*—The proposed model would allow an S entity to designate as debt any type of instrument if the financial rights of the holder included only (1) annual or more frequent periodic payments in a fixed dollar amount and (2) a distribution on retirement of the instrument in a specified dollar amount.[41] An instrument meeting these requirements would be subject to all of the rules for debt instruments, both as to the entity and to the holder of the instrument, whether the instrument is called a debt instrument, preferred stock, or a partnership interest, or bears some other label. An interest designated as debt would not be considered a second class of equity interests, and holders of these interests would not be counted against the 100-equity-holders ceiling. The designation would have to be made when the instrument is issued, and a revocation of the designation would be treated as a payment of the original instrument and the issuance of another.

Professor Kwall would also allow a conduit entity to issue debt-like preferred instruments, but he apparently would not require that the annual return be paid immediately and would treat a preferred interest as either debt or equity, depending on how it is structured (e.g., as debt if it takes that form or as equity if it is or resembles preferred stock).[42] However, treating such instruments as equity could raise complex allocation issues, particularly if the annual return is not paid currently. For example, if cumulative preferred stock is treated as equity, what allocation should be made to the shareholder for a particular year if entity taxable income for the year is less than the preferred dividend? If the entity has adequate taxable income, but most of it is long-term capital gain, should the allocation to the preferred shareholder be ordinary income or capital gain? If the dividend is not paid for a particular year and cumulates to the following year, should the allocation to the holder for the year be the amount of the dividend, some lesser figure representing the present value of the eventual distribution, or zero? The proposal made here is that a preferred instrument should violate the second class of equity rule unless it exhibits the principal tax characteristics of debt—fixed payment obligations; the annual return on such a debt-like instrument should be treated as interest, deductible by the entity and taxable as ordinary income to the holder, whether it is paid or not and regardless of the amount or character of the entity's income.

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41. The requirement that the annual payment be a fixed dollar amount should be considered met if the payment is expressed as a percentage of the amount payable on retirement.

42. See Kwall, supra note 5, at 246-48.

3. *Contributions.*—Under present law, gain or loss is rarely recognized on a transfer of property to a partnership in exchange for a partnership interest, and nonrecognition is allowed on a transfer of property to a corporation (including an S corporation) in exchange for stock if the transferor or transferors own at least 80% of the corporation's stock immediately after the transfers.[43]

The tradition of nonrecognition on property transfers incident to entity organization is long and firmly established, and probably for good reason. Requiring gain or loss to be recognized on such a transfer is seen as placing an undue burden on taxpayers' ability to organize and reorganize their business affairs.[44] Nonrecognition on transfers to conduit entities raises at least one obvious problem: Gain or loss accrued to the contributing owner before the property's contribution may be shifted, at least in part, to other owners of the entity when the entity sells or uses the property. This shifting opportunity could be eliminated by requiring the contributing owner to recognize gain or loss as though the property were sold to the entity at its fair market value. However, the nonrecognition tradition is probably so firmly based in history and business convenience that it cannot feasibly be reversed. Therefore, under the proposed model, no gain or loss would be recognized by a person contributing property to an S entity in exchange for an equity interest in the entity or by the entity on receiving the property.[45] The possibility of restricting this nonrecognition rule to limit shifting opportunities is discussed further below.[46]

Historically, the law has not allowed nonrecognition on transfers of property in exchange for debt instruments. Therefore, if property is contributed to an S entity in exchange for an instrument issued by the entity that the entity designates as debt, the contributor should be treated as selling the property, and the entity as purchasing it, for a price equal to the instrument's principal amount.

4. *Distributions.*—Presently, when a partnership distributes property other than money to a partner, gain or loss is generally not recognized by either the partnership or the partner.[47] An S corporation, in contrast,

43. See IRC §§ 351(a), 721.

44. See Kwall, supra note 5, at 254.

45. Professor Kwall would also allow nonrecognition on property transfers to an entity upon its organization, but gain or loss would be recognized on a subsequent transfer to the entity unless the transferor's interest in the entity was at least 80%. See Kwall, supra note 5, at 254-58.

46. See infra text accompanying notes 54-56.

47. See IRC § 731(a), (b).

recognizes gain on a distribution to a shareholder as though the property were sold to the shareholder at its fair market value.[48]

Even in its original formulation of subchapter K, Congress acknowledged that the partnership rules on distributions, if not limited, would leave too much opportunity for partners to shift gains and losses between them. Under section 751(b), enacted in 1954, a partnership distribution is treated as a constructive sale of property between the distributee and the partnership to the extent that the distribution changes the partner's proportionate interests in various types of property that would generate ordinary income on sale. Since most property distributions shift gain or loss inherent in the distributed property from the partners, collectively, to the distributee individually, Congress essentially decided that this distortion was acceptable so long as it does not relate to the designated ordinary income assets. On several subsequent occasions, Congress has identified other contexts in which shifting of potential income, deduction, gain or loss by distributions was no longer tolerable.[49] The resulting patchwork is one of the principal repositories of unworkable complexity in the present subchapter K.

Under the proposed model, an S entity would generally recognize gain or loss on any distribution of property to an owner, computed and characterized as though the property were sold to the distributee at fair market value.[50] This rule would usually eliminate the possibility of a distribution shifting potential income, gain, or loss to other owners. However, it would sometimes allow an entity's owners to cause gain or loss to be recognized without substantially changing the beneficial ownership of the distributed property. Arguably, loss recognition should therefore be restricted.[51]

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48. See IRC §§ 311(b), 336.

49. See IRC § 704(c)(1)(B) (partner who contributed property to partnership recognizes gain or loss accrued at time of contribution if property is distributed to another partner within seven years after contribution), enacted in 1989; § 707(a)(2)(B) (distribution, coupled with distributee's transfer of property to partnership, treated as sale or exchange if that is substance of transactions), enacted in 1984; § 731(c) (marketable securities treated as money for purposes of rule requiring distributee partner to recognize gain to extent money received exceeds basis of partnership interest), enacted in 1993; § 737 (distributee taxed on gain inherent in property contributed by distributee during preceding seven years unless distribution is of contributed property), enacted in 1993.

50. Professor Kwall would provide nonrecognition on a distribution in liquidation of the entity if the owners continued the business in another form. See Kwall, supra note 5, at 260. This exception is not included in the model proposed here because, as discussed below, a change in form of organization is not treated as a distribution unless the new organizational form is not an S entity.

51. Compare IRC §§ 267(a)(1), 707(b)(1).

5. *Allocations of Income, Loss, and Credit.*—Since the proposed model would restrict an S entity to having only one class of equity interests, the allocation of the entity's gross income, deductions, and credits among the owners should usually be relatively simple. Each owner would be allocated a constant percentage of each such item.

This simple allocation scheme, like that of the present subchapter S, makes no provision for a significant group of problems alluded to earlier. When an S entity receives appreciated or depreciated property as a capital contribution from one of its owners, the gain or loss accrued in the property at the time of contribution is, when realized by the entity, allocated ratably to all of the owners. Similarly, when an S entity owning appreciated or depreciated property issues an additional equity interest, gain or loss accrued before the issuance of this interest is, when subsequently realized by the entity, allocated in proportionate part to the holder of the new interest. Conversely, if an S entity redeems an equity interest, the redeemed owner's share of appreciation or depreciation in property of the entity not distributed in the redemption is allocated to the remaining owners when the entity ultimately recognizes it. Property contributions and issuances and redemptions of equity interests are therefore vehicles by which gain or loss accrued to one person or group of persons may be shifted to another person or group of persons.

The partnership rules presently require that gain or loss inherent in contributed property at the time of contribution be allocated to the contributing partner when it is realized by the partnership.[52] When a partnership issues new partnership interests, it may, but need not, revalue partnership assets and restate the partnership books to ensure that accrued gains and losses will, on realization, be allocated to the partners in proportion to their interests when the gain or loss accrued.[53] The rules provide no procedure by which a departing partner may be taxed on the partner's share of accrued gains and losses on undistributed property.

As Professor Kwall notes, the shifting potential of the S rules has not been considered problematic.[54] However, the proposed model would expand the categories of entities eligible to utilize subchapter S (e.g., to include entities with corporate owners), and subchapter S would be attractive to much broader classes of investors (e.g., because of the rules on liabilities discussed below). Although the proposed one-class-of-entity-interests requirement might lessen the problem of gain and loss shifts, this problem might not be greatly different under the proposed subchapter S than it was under subchapter K

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52. See IRC § 704(c).

53. See Regs. § 1.704-1(b)(2)(iv)(*f*), (*g*).

54. See Kwall, supra note 5, at 258.

immediately before Congress, in 1984, adopted the present partnership rules on contributed property.[55]

The model proposed here nevertheless follows the present subchapter S on this point. The partnership rules on contributed property are complex and not wholly effective.[56] They are also arbitrary in that they closely regulate one type of shifting of gain and loss, while leaving analogous shifting opportunities subject either to an elective rule or to no rule at all. Although the S approach opens opportunities for manipulation, particularly under the more broadly available subchapter S in the proposed model, the burdensome complications of the partnership limitations are not justified by what they accomplish.

6. *Loss Limitation; Liabilities in Basis.*—Under both subchapter K and subchapter S, an equity owner can deduct entity losses only to the extent of the basis of the owner's interest.[57] However, the adjusted basis of a partnership interest includes the partner's share of partnership liabilities,[58] but an S corporation's liabilities have no effect on the shareholders' bases for their stock. The partnership rules greatly facilitate partners' deductions for artificial losses generated by partnership investments.

The S example better serves the goal of simplicity. The partnership rules are complex, particularly as applied to liabilities for which some partners have personal liability and some do not. Generally, a partner's share of a liability is the portion of the liability for which the partner or a related person "bears the economic risk of loss,"[59] but if no partner bears this risk, the liability is allocated among the partners according to a three-tier formula.[60] All obligations among the partners, as well as to third persons, are taken into account in determining whether partners have personal liability and, if so, the proportions in which they bear the economic risk of the liability.[61] None of these determinations are required for S corporations.

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55. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71(a), 98 Stat. 494, 589 (1984).

56. See Regs. § 1.704-3. The complexity and ineffectiveness both derive in significant part from the regulations' "ceiling rule," which applies when, among other things, property appreciates before it is contributed to the partnership and then depreciates in the partnership's hands or vice versa. See Laura Cunningham, Use and Abuse of Section 704(c), 3 Fla. Tax Rev. 93 (1996).

57. See IRC §§ 704(d)(1); 1366(d). A partner can deduct losses only to the extent of the basis of the partnership interest, but an S shareholder can deduct losses to the extent of the sum of the bases of the shareholder's stock and corporate debt held by the shareholder.

58. See IRC § 752.

59. Regs. § 1.752-2(a).

60. See Regs. § 1.752-3(a).

61. Regs. § 1.752-2(a).

The facial simplicity of the S approach is undercut by frequent disputes between the IRS and S shareholders over whether corporate borrowings from third persons should be considered, in substance, to be borrowings by the shareholders, followed by capital contributions or loans by the shareholders to the corporation.[62] Whether a corporate liability is reflected in a shareholder's basis often depends more on the form of the transactions than on the substance of the parties' rights and interests, particularly if the shareholder guarantees the liability.

A more fundamental problem with the S approach, particularly if it is used in the only conduit regime available to most business entities, is that it draws a sharp distinction between proprietorships and multiowner enterprises and between co-ownership of property and ownership through an entity. The partnership liability rules are essentially an extension of the *Crane* doctrine, which includes in a taxpayer's cost basis for property any portion of the cost that the taxpayer paid with borrowed money, by assuming a liability, or by taking the property subject to a debt.[63] To deny liability flow-through in the only generally available conduit regime for business entities probably gives the entity too much significance.

However, the factual determinations required by the partnership rules are complicated. Under *Crane*, a liability may be included in a property owner's cost whether or not the owner has personal liability.[64] This rule has the advantage of avoiding the often difficult and sometimes economically meaningless question of whether a liability is with or without recourse. In an entity context, an equity owner personally liable for an entity debt has a better claim to basis for the obligation than an owner without personal liability, but administration of this distinction adds too much complexity in relation to the fairness benefits obtained from the distinction. Each equity owner's proportionate share of each liability of the entity should be the same as the owner's proportionate share of entity income and loss, and the holder's personal liability on the indebtedness, or lack thereof, should be ignored.

7. *Effects of Elections and Terminations.*—Presently, a C corporation's election to be an S corporation does not interrupt the corporation's existence for tax purposes or trigger recognition of gain or loss in the corporation's assets. However, a conversion of a partnership into an S corporation or of a corporation into a partnership is treated as a liquidation

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62. Compare Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) (corporate borrowing, guaranteed by S shareholder found to be, in substance, loan to shareholder followed by shareholder loan to corporation), with Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir. 1989) (contra).

63. Crane v. Commissioner, 331 U.S. 1 (1947).

64. Id.

of the old entity and a transfer to the new entity.[65] The provisions of subchapter S dealing with former C corporations are among the most complex of the rules applicable to S corporations.[66]

Under the proposed model, a C entity becoming an S entity or an S entity electing to be a C entity would be treated as making a liquidating distribution of all of its assets, subject to its liabilities, to its equity owners as of the close of business on the day preceding the effective date of the election or termination, and the equity owners would be treated as contributing the assets, subject to the liabilities, to the S or C entity before the start of business on the following day. Gain or loss would be recognized on the constructive liquidation as though the corporation had sold its assets to the equity owners.

8. *Application of Subchapter C.*—Presently, all provisions of subchapter C apply to S corporations, excepting those that are either expressly made inapplicable or are "inconsistent with" subchapter S.[67] Because the proposed model brings partnerships, limited liability companies, and other unincorporated business entities into the S regime, it is not appropriate that subchapter C have any application to S entities.

One consequence of the present incorporation of subchapter C into subchapter S is that an S corporation can be a corporate party to a reorganization, whereas a partnership cannot. For example, if an S corporation's assets are acquired by another corporation in exchange for voting stock of the latter and the S corporation distributes the stock in complete liquidation, the transaction is a tax-free reorganization (a C reorganization), and neither the target corporation nor its shareholders recognize gain or loss.[68] In contrast, if a partnership's assets are acquired for stock in a corporation, the partnership's exchange of its assets for the stock is usually a taxable transaction.

In the remodeled subchapter S, the corporate reorganization rules would apply only to C entities, but a greatly simplified set of reorganization rules should be constructed for S entities. If an S entity's form of organization is changed (e.g., a partnership is incorporated), but the

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65. See Rev. Rul. 84-111, 1984-2, C.B. 88 (regarding incorporation of a partnership), Prop. Regs. § 301.7701-3(g)(1)(i), (ii) (elective changes in classification from partnership to association and from association to partnership).

66. See IRC §§ 1368(c) (distributions from earnings and profits accumulated before corporation elected under subchapter S); 1374 (gains inherent in corporate property at time of S election subject to corporate tax if recognized by corporation within first 10 years of election); 1375 (passive investment income of former C corporation subject to corporate tax to extent this income exceeds 25% of corporate gross receipts).

67. IRC § 1371(a).

68. See IRC §§ 354(a), 361, 368(a)(1)(C).

proportionate interests of the owners are unchanged, the new entity should be treated as a continuation of the old entity. If the assets of two S entities are combined into one entity, neither entity nor its equity owners should recognize gain or loss if the consideration received by the owners consists solely of equity interests in the surviving entity. A division of one S entity into two or more S entities should also be a nonrecognition transaction if none of the equity owners receives anything but equity interests in the surviving entities. If a transaction would be within either of the foregoing rules, except that one or more equity owners receives consideration other than equity interests in a surviving entity, the owners receiving nonqualifying consideration should be taxed as though they had sold their prior interests at fair market value, but the remaining participants in the transaction should not recognize gain or loss. In contrast, an acquisition of an S entity by a C entity, or vice versa, would be treated as a complete liquidation of the acquired entity, followed by a transfer of its assets to the acquiring entity.

C. *Subchapter C*

Under the proposed model, all business entities not covered by subchapter K or S would be subject to subchapter C. Except for entities qualifying for S status and not electing C status, this category would include all entities with publicly traded interests (essentially as under present law) and any entity with two or more owners whose capital is a material factor in the production of its income. Form of organization would not be a factor in determining whether subchapter C applies to an entity.

The reasons for this radical restructuring of the tax classification of business entities do not require that the double tax regime presently visited on C entities should apply to entities newly reclassified into subchapter C. For example, although a complex partnership cannot reasonably be treated as a conduit for income tax purposes, the complexities of the partners' sharing arrangements provide no reason for taxing the partnership's income both to the partnership as earned and to the partners when distributed. It is proposed that such a partnership be classified as a C entity only because the futility of any effort to allocate its income realistically among the partners requires that tax on the income be imposed at the entity level, not the partner level.

On the other hand, a reshuffling of the tax classification of private business entities is not necessarily the appropriate occasion for an abandonment of the classical, double tax regime for publicly held entities. Under present law, this regime generally applies to entities with publicly traded interests, regardless of form of organization.[69] This situation should continue until Congress undertakes the separable task of reexamining its commitment to the regime.

However, given the artificiality of distinguishing for tax purposes between partnerships, corporations, and business entities organized in other ways, a single level of tax, not a double tax, should apply to all nonpublic business firms. It is therefore proposed that

1. Any C entity having at least one class of publicly traded equity interest and the holders of its equity interests should continue to be subject the double tax regime, and debt issued by the entity would remain subject to the present rules for debt.
2. All other C entities should be taxed at a flat rate equal to the highest marginal rate for individuals (presently, 39.6%).
3. Nonpublic C entities should be allowed no deduction for interest expense, but consistent with the single-tax objective of this model, interest, dividends, and other distributions from other nonpublic C entities should be excluded from gross income.
4. Holders of equity and debt instruments issued by nonpublic C entities should be exempted from tax on interest, dividends, and other distributions from the entities.

The system proposed for nonpublic C entities is essentially the Comprehensive Business Income Tax (CBIT) suggested by the Treasury in 1992 for all C entities.[70] According to the Treasury, "CBIT would equate the treatment of debt and equity, would tax corporate and noncorporate businesses alike, and would significantly reduce the tax distortions between retained and distributed earnings."[71]

The CBIT is not, of course, a simple, perfect solution to the problem of double taxation.[72] For example, it is not obvious how gains and losses on

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69. See IRC § 7704 (partnership treated as corporation for federal tax purposes if partnership interests are traded on established securities market or readily tradable on secondary market).

70. See U.S. Dep't of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once, 39-60 (1992) [hereinafter Treasury Study].

71. Id. at 39.

72. Another problem addressed by the Treasury study is that the CBIT, without some modification, would allow equity owners to enjoy indirectly the benefits of all tax preferences available to the entity, whereas, under present law, shareholders of C corporations are usually taxed when corporate income protected by tax preferences is distributed as dividends. The Treasury proposed to preserve the status quo on this issue by imposing an

sales of equity interests should be treated under a CBIT. To the extent that the enhanced value of an equity interest derives from undistributed income of the entity, an entity-level tax has effectively already been paid on the equity holder's gain, and a tax on the gain would therefore violate the goal of taxing the entity's income only once. On the other hand, to the extent that the enhanced value derives from unrealized gains in the entity's assets, an exemption of the owner's gain from tax would allow the owner to cash out his or her share of the unrealized gains without tax. Although the gains may subsequently be taxed to the entity when it sells the assets, the law has not historically allowed the taxation of gain to be delayed beyond the time when the beneficial owner receives cash for it.

The Treasury proposed to solve this problem by taxing gains on sales of equity interests, and allowing deductions for losses, as under present law, but adopting a dividend reinvestment plan (DRIP) procedure that would allow entities to treat parts or all of their earnings as having been distributed and reinvested by the equity owners.[73] The DRIP procedure would have the effect of increasing the tax bases of equity interests by the amounts deemed distributed.

As Professor Yin points out, the DRIP procedure is not problem-free in this model.[74] Many nonpublic C entities are so classified in the model because their owners have adopted complex schemes for sharing profits and losses. For them, the imposition of entity-level tax is justified by the fact that conduit taxation, based on allocations of entity income among the owners, would be artificial and susceptible to manipulation. A DRIP procedure could be implemented only by making such an artificial allocation. The potential for manipulation could be reduced by allowing a DRIP election for a particular year to apply only to income for that year, thus precluding entities from allocating earnings for several years only after it is clear how the

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additional compensatory corporate tax on distributions of preference income. See Treasury Study, supra note 70, at 43-45. See id. at 45-48 (proposing to treat foreign income insulated from U.S. tax by foreign tax credit as corporate preference income).

The compensatory tax would be complex, and it probably is not needed in this model. Although the Treasury proposed the CBIT for all business entities (excepting only those with annual gross receipts less than $100,000), the present proposal uses the CBIT only for private business entities, nearly all of which are or could be organized as partnerships or other entities presently eligible to be taxed as partnerships. Since partners have always had the benefit of tax preferences available to the partnership, a CBIT without the compensatory preference tax would not significantly broaden the enjoyment of tax preferences.

73. See Treasury Study, supra note 70, at 81-88.

74. See Yin, supra note 14, at text accompanying notes 74-76.

allocation would advantage the owners.[75] However, the arbitrariness and manipulation potential of the required allocations cannot be denied.

Alternatively, the equity holder's gain could be exempted from tax, but the entity could be required to recognize gain or loss as though all of its assets were sold at fair market value if, at any time, one or more persons owned a proportion of the equity interests that was more than a specified amount (e.g., 50%) higher than the smallest proportionate interest of these persons during a specified period of time (e.g., the preceding three years).[76] This approach suffers from at least two faults: Execution of it would be complex, and it would have the effect of taxing the shares of corporate gain allocable to the interests of equity holders who do not sell their interests.

In sum, the capital gains problem has no easy solution. On balance, the best solution seems to be to require the entity to recognize gain when a major portion of the equity interests have been sold. This approach concentrates tax calculations in the entity and thus is more consistent with the thrust of the CBIT to tax entity income only at the entity level.

VI. CONCLUSION

Subchapter K has a terminal illness. For several decades, aggressive tax planners have used partnerships as a vehicle for shifting income and loss arbitrarily between partners, and Congress and the Treasury have found it necessary to respond to these uses of the partnership by adopting progressively more complicated restrictions on the fairly simple conduit regime found in the original enactment of subchapter K. The result is a system of unworkable complexity that still does not adequately guard against manipulative shifting of income and loss. The problem is not that Congress and the Treasury have done a poor job of making the law. The problem is that conduit taxation is not feasible for firms with complex arrangements for sharing firm income and loss. Congress and the Treasury, in trying to develop a conduit regime acceptably free of abuse potential, have been attempting the impossible.

Before the patient expires, Congress should radically reshuffle the respective jurisdictions of subchapters K, S, and C. Form of organization should no longer play any role in an entity's tax classification. Subchapter K should only remain available to service entities for which capital is not a

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75. It would not be desirable to require the entity to adopt procedures ensuring that the earnings allocated to a particular interest would ultimately be distributed to the holder of that interest because this would return to the accounting now required by the substantial economic effect test.

76. See IRC §§ 338, 384; see also Yin, supra note 14, at text accompanying note 79.

material income-producing factor. The more restrictive conduit regime of subchapter S should be opened to all private business firms with simple capital structures and should be revised to incorporate as much of the flexibility of subchapter K as is possible without making it unreasonably susceptible to abuse. All firms with more complex ownership structures should be subject to subchapter C, but the incomes of private business firms within subchapter C should only be taxed once. The taxable income of a private C entity should be determined without deduction for interest expense, and returns received by the entity's owners and creditors (e.g., dividends and interest) should be exempt from tax.