Subchapter S Out the Window? What's Going On?

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In this report, Taylor summarizes the House Ways and Means Committee's draft legislation to reform the taxation of passthrough entities. He focuses on option 2, which would eliminate subchapter S and provide a single set of rules for passthroughs, whether corporations or partnerships. Taylor argues that whether an entity is incorporated should be irrelevant to its tax treatment and that the discussion draft, by putting that issue to the side, properly requires us to focus on why there should be different income and payroll tax rules for S corporations and partnerships.

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I. Introduction

The tax reform discussion draft on the taxation of passthroughs that was released by the House Ways and Means Committee on March 12 includes two options for structural reform.[1] Option 1 would make specific changes to the S corporation and the subchapter K partnership rules. Option 2, while incorporating the option 1 changes, would go much further and fundamentally redo subchapters K and S, resulting in a single set of rules for all nonpublicly traded passthroughs and some publicly traded passthroughs.[2] There is no revenue estimate for either option. The changes would take effect in 2014, without any grandfathered exceptions.[3]

The specific changes in option 1 are not new. They are essentially items that have been proposed for some time. For S corporations, option 1 would make most of the industry-backed changes in the S Corporation Modernization Act of 2013 and its predecessors.[4] For partnerships, option 1 would make more significant changes, although still

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[1]It also includes provisions directed at small businesses, such as the expensing of some expenditures and the use of cash method accounting, and changes to the due dates for business tax returns. *See* Ways and Means Committee, "Technical Explanation of the Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities" (Mar. 12, 2013) (technical explanation).

[2]The unified rules would apply to publicly traded partnerships that have met the "good" income exception from the rule that generally treats publicly traded partnerships as corporations. *See* section 7704(c).

[3]Transition rules "with a goal of minimizing disruption" were identified as an unaddressed issue in the Ways and Means Committee release, "Strengthening the Economy and Increasing Wages by Making the Tax Code Simpler and Fairer for America's Small Businesses" (Mar. 12, 2013) (release).

[4]H.R. 892, the S Corporation Modernization Act of 2013 (Feb. 28, 2013), would (1) permanently reduce to five years the gain recognition period for built-in gain; (2) eliminate the rule that disqualifies an S corporation if it has accumulated earnings and profits and its passive income is more than 25 percent of its gross receipts for three consecutive years; (3) raise from 25 to 60 percent of gross receipts the threshold for taxing an S corporation that has accumulated E&P on net passive income; (4) allow an electing small business trust that is an S corporation shareholder to have a nonresident alien as a potential current beneficiary; (5) allow an electing small business trust to take a charitable deduction under the rules that apply to individuals;

(Footnote continued on next page.)

largely cleanups. They are listed at the end of this report. There is no single source for the partnership changes. Several are proposals that were put forward in a 1997 Joint Committee on Taxation paper but not enacted as part of the Taxpayer Relief Act of 1997, and others come from comments made over time by practitioners and academics.[5]

Option 2 would be much more significant, both for partnerships and S corporations, and its economic importance should not be underestimated. Passthroughs — whether S corporations, limited liability companies, or partnerships — are a large and growing segment of the economy, and that is unlikely to change.[6]

In 1980 C corporations accounted for 16.6 percent of business tax returns and 86.2 percent of business receipts, S corporations accounted for 4.2 percent of business tax returns and 3.2 percent of business receipts and partnerships accounted for 10.6 percent of business tax returns and 4.2 percent of business receipts. By 2007 S corporations accounted for 12.8 percent of business tax returns and 19.8 percent of business receipts, partnerships accounted for 10 percent of business tax returns and 14.3 percent of business receipts, and C corporations accounted for 5.62 percent of business tax returns and 72.1 percent of business receipts. Thus, passthroughs' percentages of business tax returns and business receipts grew from 14.8 and 7.4 percent to 22.8 and 34.1 percent, primarily because of the growth of S corporations — and despite the check-the-box regulations. In 2008 there were more than 4 million S corporations and 3 million partnerships (of which 1.9 million were LLCs). There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. The shift from C corporations has contributed to the decline in corporate tax revenues to about 10 percent as a component of federal tax revenues.

II. What Does Option 2 Do?

Option 2 would replace subchapters K and S with a new subchapter K that would apply to partnerships that were not publicly traded (or, if publicly traded, were still partnerships because of the ''good'' income exception in section 7704(c) to the rule that generally treats publicly traded partnerships as corporations), and would be available to any corporation, other than one ineligible to be an S corporation under current law,[7] if it were not publicly traded and elected to be taxed under the new rules.[8] Outside subchapter M, which deals with regulated investment companies and real estate investment trusts, this would be the exclusive passthrough regime for corporations and partnerships.

Option 2 would generally not change the definition of a partnership, the definition of what constitutes an entity subject to classification as a partnership or a corporation (such as a cell company), or the treatment of disregarded entities.[9] Foreign corporations would be eligible to be passthrough entities, if not publicly traded, even if they are per se corporations under the section 7701 regulations.[10] Option 2 would keep the statutory exclusions from partnership classification in section 761.[11] It would also keep section 704(c), concerning family partnerships, but only in a case in which an individual (as opposed, for example, to a corporation) acquired a capital interest in a passthrough from another family member.[12]

When is a corporation publicly traded? The technical explanation accompanying the discussion

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(6) make permanent the reduced basis adjustment to a shareholder's shares resulting from a charitable contribution by an S corporation of appreciated property; and (7) extend the time for making an S corporation election to the due date for the filing of the corporation's return. *See also* H.R. 1478, the S Corporation Modernization Act of 2011 (Apr. 12, 2011); and American Bar Association Section of Taxation, ''Options for Tax Reform in Subchapter S of the Internal Revenue Code'' (Apr. 10, 2013).

[5]*See* JCT, ''Review of Selected Entity Classification and Partnership Tax Issues,'' JCS-6-97 (Apr. 8, 1997). *See also* sources cited by the technical explanation, *supra* note 1, at 20, 22, and 29, including William B. Brannan, ''The Subchapter K Reform Act of 1997,'' *Tax Notes*, Apr. 7, 1997, p. 121. On the fate of the JCT proposals, see John S. Pennell and Philip F. Postlewaite, ''Subchapter K — Have the Joint Committee Proposals and TRA '97 Given It a New Look?'' 87 *J. Tax'n* 325 (1997).

[6]The data in the text below are largely taken from the IRS Statistics of Income division. Measuring entity selection by business returns filed and business receipts reported seems more informative than focusing on S corporations as a percentage of the returns and receipts of all corporations.

[7]An insurance company, a bank that uses the reserve method of accounting for bad debts, a domestic international sales corporation, or a former DISC. It would, however, be available to foreign corporations.

[8]An existing S corporation would be deemed to elect to be taxed under the new rules unless it affirmatively elected not to be a passthrough corporation. A passthrough election by a corporation can be revoked only with the IRS's consent.

[9]This may be a concern because of the ease with which a disregarded entity could be turned into a partnership. *See* Monte A. Jackel, ''A Short Journey Into Some Needed Reforms in the Partnership World,'' *Tax Notes*, Dec. 3, 2012, p. 1109.

[10]Like the check-the-box regulations, this may increase international arbitrage — that is, situations in which an entity is a corporation for foreign tax purposes but a passthrough in the United States.

[11]As under current law, partnerships would not include the unincorporated entities described in paragraphs (a), (b), or (c) of section 761. The section 761(f) exclusion for joint ventures between a husband and wife would remain.

[12]Thus putting to rest the taxpayer's argument in *TIFD III-E Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012).

draft says that for a corporation, the definition of publicly traded is "intended to be broader than the definitions under present law." The proposed definition refers specifically to section 1273(b), as well as to section 7704.[13] The section 1273(b) regulations treat instruments as publicly traded if there is a sale, a firm quote, or an indicative quote. The rules, which focus on whether there is a reasonable basis to determine value, are very inclusive.[14] The section 7704 regulations have a different focus, not on determining value but on whether there are readily available, regular, and ongoing opportunities to sell. The broader definition will limit the population of corporations that can move into subchapter K, possibly excluding some existing S corporations.

A. Moving In and Out of New Subchapter K

Under option 2, an election by a corporation (whether a C corporation or a former S corporation) to be a passthrough would not be a taxable event, although the special rules that apply to built-in gain and to passive income of, or distributions by, corporations with accumulated E&P would, as modified under option 1, remain.[15] Thus, an S corporation could generally move into new subchapter K without interrupting its passthrough treatment. Nor would there be a taxable event if a passthrough corporation or partnership no longer qualified as a passthrough (for example, if it became publicly traded) and moved out of new subchapter K and was henceforth treated as a corporation. The classification of a partnership that was or became publicly traded would continue to depend on whether it met section 7704(c)'s "good" income exception to the general rule that a publicly traded partnership is treated as a corporation. A publicly traded corporation could not move into new subchapter K without a taxable liquidation because the passthrough election is available only if the corporation is not publicly traded. And if the corporation did liquidate, it would have to satisfy the "good" income exception to be classified as a partnership.[16]

Option 2 would significantly change the treatment of partnerships and nonpublicly traded corporations that elect to be passthroughs. Although there have been many proposals for reforming subchapter K, few are as straightforward as this.[17]

Thus, for S corporations, the one-class-of-stock and shareholder-level eligibility rules would be eliminated, as would the back-to-back loan issue.[18] There would be no more QSubs,[19] no ability to use an S corporation as a "mixing bowl," no section 338(h)(10) elections, and no more tax-free reorganizations or spinoffs, except to the extent feasible under new subchapter K (as opposed to subchapter C).

For partnerships, the most significant changes would be (1) new restrictions on allocations of passthrough items to owners; and (2) importing the subchapter S rule, the recognition of gain by the passthrough, and the recognition of gain (and sometimes loss) by the owner on a distribution of property.

III. New Subchapter K

The option 2 rules for passthroughs would incorporate all the option 1 changes to current subchapter K and go further.

A. Single Distributive Shares

Although the general passthrough rules, such as what passes through to an owner and the retention

[13]The technical explanation, *supra* note 1, refers both to the section 1273(b) and section 7704 regulations. Under reg. section 1.7704-1(c)(1), interests not traded on an established securities market are publicly traded (as a general rule, and subject to five safe harbors) if "taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market." Trading on a secondary market or its equivalent generally requires readily available, regular, and ongoing opportunities to sell. Reg. section 1.7704-1(c)(2).

[14]Under the section 1273(b) regulations, for example, debt can be publicly traded if at any time in a 31-day period beginning 15 days after its issuance "there are one or more indicative quotes," defined as being the case "when a price quote is available from at least one broker, dealer, or pricing service . . . for the property and the price quote is not a firm quote," or if there is a sale of the instrument within that period. Reg. section 1.1273-2(f).

[15]That is, the rules that (1) tax passive income if it is more than 60 percent of the corporation's gross income; (2) tax a corporation on built-in gain if the property is disposed of within five years; (3) require a former C corporation to keep an accumulated adjustments account to segregate C corporation E&P (and tax distributions out of that account as dividends); and (4) require the recapture of last-in, first-out reserves when a C corporation becomes a passthrough entity. Also, there would be no carryover of C corporation losses to the passthrough entity or from a passthrough entity to a C corporation.

[16]And thus publicly traded partnerships that wanted to be passthroughs would, as they do today, choose to become REITs if able to qualify.

[17]For one exception, see Walter D. Schwidetzky, "Integrating Subchapters K and S — Just Do It," 62 *Tax Law.* 749 (2009). Although the Senate Finance Committee has released several "Tax Reform Options for Discussion," none of the proposals thus far have included structural changes to subchapter K or S.

[18]Debt of a corporation that was a passthrough would be treated the same way as debt of a partnership passthrough and thus could be included in the owner's basis. *See* release, *supra* note 3 (stating that option 2 will conform S corporations "to the basis rules that currently apply to partnerships").

[19]However, disregarded entities would be available, as would passthrough corporations if treated in effect as disregarded entities.

of its character and source would remain the same, option 2 would make the following changes:

1. an owner's distributive share would be determined on the basis of the owner's economic interest in the passthrough;

2. regardless of whether an allocation is consistent with the owner's economic interest, there can be only a single distributive share of items within each of three categories: ordinary items, capital gain rate items (which would include ''qualified'' dividends), and tax credits (other than the foreign tax credit); and

3. an owner's distributive share of foreign income taxes (and the related deduction or credit) would be based on the owner's share of the passthrough items on which the foreign taxes were imposed.[20]

The discussion draft contemplates that regulations will prevent the avoidance of the restriction on distributive shares through, for example, the use of passthroughs under common control.

The single distributive share rule (which is intended to ''Reduce the use of complex structures to engage in tax avoidance'')[21] would prevent owners from splitting ordinary deductions, capital losses and capital gains, and foreign- and U.S.-source ordinary income.[22] That is a major change for partnerships. Many of the illustrations in the section 704(b) regulations would be closed down before being evaluated to determine whether they have ''substantial economic effect.''[23] Conversely, the single distributive share rule may restrict the flexibility that partnerships now provide — for example, when a professional services firm has NRA and U.S. partners and allocates foreign-source income to the foreign partners.[24]

The single distributive share rule is obviously less important for passthrough corporations, since under subchapter S they are now limited to one class of stock. Under the option 2 changes, a corporation that elects into subchapter K would be able to have more than one class of stock. That is important. S corporation banks, for example, have urged that they be able to issue preferred stock, which would be feasible under option 2.

Are there holes or unresolved issues in the single distributive share rule:

- For example, into what share does tax-exempt interest go? Possibly in the ordinary item share, because that is ''any passthrough item which is not in'' another category. But does it make sense to combine tax-exempt interest with other ordinary items?
- The distributive shares focus on individual tax rates. Do they make sense for corporate partners? For example, for a corporate owner, does it make sense to group dividends that are eligible for the dividends received deduction with net capital gain, which is taxed at the same rate as ordinary income?
- Is the single distributive share rule for each year or for longer periods? Shifting, or transitory, allocations that change from year to year are, of course, an important focus of the substantial economic effect rules.
- Why are credits a separate distributive share, at least if (like the research expenditure credits, for example) they are based on expenditures that are included in the ordinary items distributive share?
- And, out of curiosity, where did the single distributive share rule come from?[25] Is it in part a product of the proposed withholding tax?

It is unclear to what extent the partnership allocation rules will change apart from the single distributive share rule. The distributive shares would still have to be tied to something, such as capital accounts, which is presumably what the economic interest rule will require. However, the concept of substantial economic effect would be eliminated,

[20]This seems to be more or less the same as the rule in reg. section 1.704-1(b)(4)(vii)(a), and it puts to rest structures like that in *Pritired 1 LLC v. United States*, 816 F. Supp.2d 693 (S.D. Iowa 2011).

[21]Release, *supra* note 3.

[22]*See* the one example in the technical explanation, *supra* note 1:

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

[23]*E.g.*, reg. section 1.704-1(b)(5), examples 1, 3, 10, and 12.

[24]Reg. section 1.704-1(b)(5), Example 10. However, the release, *supra* note 3, identifies the proper treatment of foreign partners as an unaddressed issue.

[25]*See*, as one possibility, the default rule suggested by Andrea R. Monroe, ''Too Big to Fail: The Problem of Partnership Allocations,'' 30 *Va. Tax Rev.* 465 (2011) (all tax allocations ratably based on the partners' relative capital account balances), and similar rules suggested by others as listed by Monroe, *id.* at n.168.

and without elaboration on what "economic interest" means (beyond that it is to be determined on the basis of all the facts and circumstances), the effect of the single distributive share rule is uncertain. Liabilities are not mentioned in the technical explanation, and section 752 would not be changed.

B. Property Distributions

Gain (but not loss) would be recognized by a passthrough entity on a distribution of property to the owners, and gain or loss would be recognized by an owner on the receipt of property distributed by the passthrough (but with the loss deferred until the termination of all the owner's direct or indirect interest in the passthrough). The basis in loss property to the owner cannot exceed the owner's basis in the owner's interest in the passthrough. The Ways and Means Committee release describes those changes as intended to "prevent owners from gaming the tax system by using losses to reduce tax liability," to "ensure that taxes are paid on real, economic gains," and to "prevent the use of passthrough entities to shift gains and losses amongst owners with different tax profiles."

How would the gain/loss recognition rules affect passthrough mergers, divisions, and reorganizations? The Ways and Means Committee release identifies this area as an unaddressed issue. The need to do so is evident. Whether a passthrough is a corporation or partnership, a merger,[26] division, or reorganization may involve transfers of assets, exchanges of ownership interests, or distributions of property. Under the general rules of new subchapter K, some of those transactions, including distributions of property,[27] would result in the recognition of gain unless there are separate rules.

Section 708 of the draft provides (as before in the case of a partnership) that in a merger or consolidation, a passthrough would continue if its owners have more than 50 percent of the survivor and that a passthrough resulting from a split-up or division would continue if more than 50 percent is owned by the prior owners. Does this imply that the effect of a merger, division, or reorganization is limited to a noncontinuing passthrough and its owners? That subchapter K will be the starting point for addressing mergers, divisions, and reorganizations?

C. Other Changes

Leaving aside the changes made by option 1, which are included in option 2, most of the other rules in new subchapter K are described by the technical explanation as "similar to," "consistent with," or the same as those in existing subchapter K.[28]

IV. Withholding Tax on a Distributive Share

Under option 2, a passthrough would be required to withhold tax, at a rate to be specified, on an owner's distributive share of the entity's net income (treating ordinary income and capital gain items separately) unless the income is subject to withholding under section 1446, which imposes withholding tax on foreign partners in a partnership. It seems unlikely that the intention is to apply section 1446 only to foreign partners in a partnership passthrough, as opposed to foreign owners of a passthrough regardless of whether it is a corporation or a partnership, but that is not clearly stated.

The new withholding tax is intended to "close the tax gap"[29] — presumably a reference to underreporting of business income by individuals, which is consistently the largest component of the gap.[30]

The new withholding tax would be treated as a distribution in determining the owner's basis in the owner's interest and as a tax paid by the owner. The credit allowed to the owner for the tax withheld would be refundable. The tax would be treated as imposed on the passthrough entity under section 11, and the failure to pay it would be treated as a failure to pay estimated corporate income tax.

New subchapter K would not include the electing large partnership provisions of subchapter K[31] or the administration's proposals regarding audits of large partnerships.[32] Because the new withholding tax would be determined at the level of the passthrough entity, however, there would be an

[26]Whether, in the case of a partnership, the merger is an assets-over or assets-up transaction.

[27]The discussion draft also provides that a distribution of a partnership interest is an exchange.

[28]*E.g.*, the exclusions from passthrough classification in section 761(a) and (f), the section 704(c) rules for contributed property, the basis limitation on an owner's share of a passthrough's loss, the nonrecognition of gain or loss on a contribution of property to a passthrough, the basis of the contributed property to a passthrough, the basis of the contributing owner's interest when there is a contribution of property, the character of gain or loss on contributed receivables, the section 707(a) and (b) rules on transactions between passthroughs and owners, the closing of a passthrough's tax year, and the determination of an owner's distributive share when the owner's interest in the passthrough changes. Likewise, the passthrough rules concerning built-in gain or accumulated E&P of a C corporation that becomes a passthrough are described as similar to those that apply when a C corporation becomes an S corporation.

[29]*See* release, *supra* note 3.

[30]*See* IR-2012-4.

[31]Sections 771 through 776.

[32]*See* Treasury, "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals," at 188 (Apr. 2013). Nor does the discussion draft mention the 1982 Tax Equity and Fiscal Responsibility Act partnership audit provisions.

entity-level determination of that tax and of the items that make up the amount subject to withholding. This would seem to eliminate any owner participation in the determination of the base for the withholding tax.[33] The Ways and Means Committee release asks, nonetheless, whether the IRS should "be permitted to audit and assess tax liability at the entity level."

V. Will Passthroughs Continue to Grow?

Would the enactment of option 2 slow the growth of passthroughs? Whatever the criticisms of option 2, a C corporation would not seem to be a better choice for a nonpublicly traded business. And S corporations, which have been the leading choice for privately held businesses, would likely find new subchapter K more accommodating than subchapter S. The complexity of new subchapter K — for example, the possibility of special allocations within the single distributive share rule — is purely optional and is unlikely to be a deterrent. What happens, of course, will depend on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes.[34] If small C corporations (those with less than $100 million of assets) were to become passthroughs, passthroughs would account for more than 50 percent of total business receipts.

VI. RICs, REITs, and Traded Partnerships

Option 2 would not affect RICs or REITs (except insofar as it makes permanent the five-year gain recognition period for built-in gain) or, generally, the status of publicly traded partnerships, which are treated as partnerships for tax purposes because of the "good" income exception in section 7704(c). The operations of those publicly traded partnerships would be subject to the rules of new subchapter K.[35] RICs, REITs, and publicly traded partnerships that are shareholders of a passthrough corporation would seem to be treated no differently than if they were partners in a nonpublicly traded partnership. Because passthrough treatment of a corporation is elective, however, they could continue to have corporate subsidiaries as blockers, including taxable REIT subsidiaries. Taxable mortgage pools may have to be addressed if option 2 moves forward.[36]

VII. Attribution of a Passthrough's Activities

Would a passthrough's activities be attributed to the owners (as is now the case for partnerships) if the passthrough is a corporation?[37] This is important in several contexts, including when there are foreign or tax-exempt owners.

If there are foreign owners, the current partnership rules (1) treat a foreign partner in a partnership as engaged in a U.S. trade or business if the partnership is so engaged[38]; and (2) treat a sale of an interest in a partnership as a sale of the partner's share of the assets of the partnership that are effectively connected, whether because of the 1980 Foreign Investment in Real Property Tax Act or otherwise.[39] The Ways and Means Committee release lists the treatment of foreign owners as an unaddressed issue. It would be odd, however, if the rules differed for a passthrough corporation and a passthrough partnership, and aligning the rules would offer an opportunity to achieve parity between foreign partners and foreign shareholders by, for example, making the withholding tax a definitive tax.

It seems clear that if there are tax-exempt owners of a passthrough, the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the section 512(b) modifications or from the passthrough's other operations.[40] This is, of course, the rule that now applies to partnerships. The Ways and Means Committee release asks whether the withholding tax should be applied to "tax-indifferent owners, such as pension funds." It would seem that it should (although possibly in a modified form), as long as there is a tax on UBTI.

The special rules in section 512(c) and (e) that apply to tax-exempt and employee stock ownership

[33]It is unclear whether this would extend to the section 1446 withholding tax.

[34]The House-passed budget would reduce the corporate rate to 25 percent and have two individual brackets: 10 and 25 percent. H. Con. Res. 112 (Mar. 2013). These are the rates targeted by the Ways and Means Committee.

[35]No changes would be made to rules that publicly traded partnerships may find annoying, such as the rule in section 708(b)(1)(B), which terminates a partnership if there is a sale or exchange of 50 percent or more of the ownership interests during the year. However, the partnership allocation rules of option 2 may affect iShare structures that some publicly traded partnerships use to attract tax-exempt investors — *i.e.*, the partnership allocations between the issuer of the iShares and the partners in the publicly traded partnership.

[36]A taxable mortgage pool is per se a corporation under section 7701(i) but may not be publicly traded.

[37]New section 711(b) provides for a passthrough of the character of items, but this may fall short of attributing the activities of the corporation to its owners.

[38]Section 875(1).

[39]Rev. Rul. 91-32, 1991-1 C.B. 107, which would be codified by the administration's fiscal 2014 budget proposals. *See* Treasury, *supra* note 32, at 57.

[40]Using the analysis of Rev. Rul. 74-197, 1974-1 C.B. 143.

plan shareholders of an S corporation may no longer apply, which would be an important issue for S corporations with ESOP shareholders — and there is an active ESOP lobby.[41] The effect of section 512(e) would be to eliminate any current tax on an ESOP shareholder's share of the income of an S corporation — that is, to defer any tax until there are distributions by the ESOP.

VIII. What's Left Out?

There have been previous proposals to change specific subchapter K rules that are not included in option 2, such as repealing or modifying the technical termination rule in section 708(b)(1),[42] eliminating the antiabuse regulations, adopting a consistent approach to the aggregate-or-entity question,[43] making the investment company definition in section 721(b) more inclusive,[44] and addressing some of the problems faced by publicly traded partnerships covered by the good income exception of section 7704(c) (such as the determination of distributive shares when interests are regularly purchased and sold, and the treatment of interests in a publicly traded partnership as securities for purposes of section 1058). Nor does option 2 address the hot-button issue of carried interest, and because subchapter K is the starting point for new subchapter K, it might be interpreted as expanding the issue to include interests in passthrough corporations.[45]

Option 2 leaves open many questions, apart from those mentioned above, such as the application of the partnership antiabuse rules and the circumstances in which a partnership would be treated as an entity or an aggregate. Without more, it would be logical to assume those rules would apply to passthrough corporations. Option 2 also leaves open several matters not addressed by subchapter K or S, other than those mentioned above, including those set out below.

A. Employment Taxes and Related Matters

The different treatment of partnerships and corporations under the Self-Employment Contributions Act (SECA) and FICA,[46] and their different treatment for purposes of provisions such as sections 469 or 1411, are not addressed. The SECA-FICA divergence is noted in the technical explanation and listed as an unaddressed issue in the Ways and Means Committee release. If there is a single passthrough system for federal income tax purposes, it would certainly be odd to have two rules for federal employment tax purposes — that is, FICA for corporations and SECA for partnerships. And the Ways and Means Committee release seems to acknowledge this when it says that option 2 ''requires *new* rules for the employment and self-employment taxes of owners'' (emphasis added). This could, of course, be a major concern for S corporations since they are perceived as offering the opportunity to limit the FICA base.

Because of the repeal of the guaranteed payment rule, the exception to the section 1402(a)(13) exclusion for limited partners would be for payments made to an owner for services rendered by the owner in a non-owner capacity. The section 1402(a)(13) exclusion from the SECA base would otherwise remain, and the discussion draft is clear that an owner may be an employee of a passthrough partnership and thus earn wages subject to FICA.[47]

B. Foreign Operations

The discussion draft does not address the disparity in the treatment of foreign income that would result if, as the Ways and Means Committee has previously proposed, active foreign income of a C corporation's foreign subsidiaries is eligible for a 95 percent dividends received deduction — no dividends received deduction would be allowed to a passthrough.[48] This is a difficult matter because if dividends to C corporation shareholders are taxed at capital gains rates, the effective U.S. tax on foreign earnings may be significantly less for a C corporation than for a passthrough. Of course, that will depend on what happens to individual and corporate tax rates (and it does not consider foreign taxes). The Ways and Means Committee release lists the taxation of foreign operations as an unaddressed issue.

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[41]*See*, *e.g.*, comments submitted by the ESOP Association to the Ways and Means Committee pension/retirement tax reform task force (undated); and S. 742, the Promotion and Expansion of Private Employee Ownership Act (Apr. 17, 3013), supported by the Employee-Owned S Corporations of America.

[42]*E.g.*, Jackel, *supra* note 9; JCS-6-97, *supra* note 5, at 40. This would be repealed by the administration's fiscal 2014 budget proposals. *See* Treasury, *supra* note 32, at 231.

[43]*Id.* Jackel, *supra* note 9.

[44]*See* New York State Bar Association Tax Section, ''Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F)'' (Dec. 28, 2011).

[45]This is addressed by the administration's fiscal 2014 budget. *See* Treasury, *supra* note 32, at 159.

[46]Because section 706(c) would be repealed, the reference to guaranteed payments in section 707(c) would be replaced by a reference to section 707(a) payments for services actually rendered to the passthrough other than in the owner's capacity as an owner.

[47]*See* release, *supra* note 3 (''provide certainty with respect to owners who actively participate in the business by allowing owners to be treated as employees of the business'').

[48]Ways and Means Committee discussion draft (Oct. 26, 2011).

C. Tax Treaties

Treating U.S. corporations as passthroughs is consistent with the right of the United States to use its definitions in applying U.S. tax treaties. In the case of inward investment, more recent U.S. treaties (and, in any event, section 894) apply uniform rules to fiscally transparent entities, whether incorporated or not.

D. State and Local Income Taxes

Many states have specific rules for S corporations (which sometimes include entity-level taxes) and partnerships. And if there is to be parity between nonpublicly traded corporations and partnerships for state and local tax purposes, those rules would have to be conformed to new subchapter K. In any event, the terms used in many state and local tax statutes (for example, references to S corporations) would have to be changed.

IX. Conclusion

Is option 2 of the Ways and Means Committee draft a good idea? Is option 1 better?

Subchapter S was enacted in 1958 to allow small business owners to achieve limited liability by incorporating but without incurring corporate tax on the corporation's income. LLCs have since eliminated the need for subchapter S. The only nontax difference between an S corporation and an LLC today is that one is incorporated and the other is not. Although that difference is unimportant as a practical matter, it results in significant federal income and payroll tax differences because of the different rules that apply to S corporations and partnerships. And the complexity of subchapter K has grown exponentially over the last 50 years. The great merit of option 2 is that in positing the elimination of subchapter S, it requires us to focus on whether the differences between subchapters S and K make any sense and on whether there are simpler ways to treat passthroughs than those in existing subchapter K. And, apart from that, the elimination of subchapter S may level the playing field by addressing the problems of small businesses caught in subchapter C.

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Option 1

Option 1 would make the following changes to partnership taxation, and they would be incorporated in option 2:

1. *Guaranteed payments*. On the basis that section 707(a) is sufficient to address payments to partners not acting in that capacity, option 1 would repeal the section 707(c) rules on guaranteed payments for services or the use of capital.[49] Payments would simply be distributions to a partner unless covered by section 707(a).

2. *Mandatory adjustment to partnership property basis*. Option 1 would eliminate the elections in sections 734 and 743, so that an adjustment to the basis of partnership property to reflect a partner's sale of a partnership interest or the partnership's distribution of property would be mandatory, not elective or dependent on there being a ''substantial'' built-in loss in partnership property after the distribution.[50] The mandatory basis adjustment rules would also apply to tiered partnerships.[51]

3. *Eliminate time restrictions on mixing bowl provisions*. Option 1 would eliminate the seven-year restrictions on the mixing bowl rules (sections 704(c)(1)(B) and 737(b)(1)) on the allocation of pre-contribution gain or loss of property when the contributed property is distributed to another partner or other property is distributed to the contributing partner.

4. *Hot asset rules*. Option 1 would broaden the hot asset rule in section 751 so that it treats a distribution of inventory to a partner as a sale, whether or not the inventory has appreciated ''substantially,'' and it would simplify the definition of an unrealized receivable so that it would include any property to the extent of the amount that would be ordinary income on a sale.[52]

5. *Deceased or retired partners*. Option 1 would repeal as obsolete sections 736 and 753, concerning payments in the liquidation of a retiring or deceased partner's interest and the treatment as income in respect of a decedent of amounts received as a successor in interest to a deceased partner.

6. *Limiting a partner's loss*. Option 1 would extend the rule that limits a partner's loss to the partner's basis in the partnership interest to deductions for charitable deductions and foreign taxes taken as a deduction (which is the rule that applies to shareholders of an S corporation).

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[49] *See* technical explanation, *supra* note 1, at 20 (saying section 707(c) has ''created a great deal of uncertainty, confusion, and controversy'').

[50] *Id.* at 27.

[51] *Id.* at 28, 55.

[52] *Id.* at 30-31.