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## The Future Taxation of Private Business Firms

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## I. INTRODUCTION

Recent federal and state law developments liberalizing the permissible forms of business organizations and the classification of such organizations for tax purposes have underscored the need to reexamine the current system of taxing the income of private businesses. This article, which undertakes that reexamination, makes two principal claims. First, current law ought to be replaced by a system whereby all private business firms, no matter what their form of organization and organizational characteristics, are taxed as conduits for income tax purposes. Second, because conduit taxation is so complicated, the system should be implemented through a "two-track" approach in which a subset of private business firms would, at their election, be subject to a simplified set of tax rules. In general, the simplified version would be available to firms which have only individuals as owners and which have surrendered some flexibility in their economic dealings.

Part II of this article briefly explains why current law merits reexamination and Parts III and IV correspond to the two main claims being made. A final part contains a brief summary and conclusion.

## II. THE NEED TO REEXAMINE CURRENT LAW

Thanks to a recent change adopted by the Treasury Department responding to important developments at the state level regarding the permissible forms of business organization, many private business firms, no matter what their organizational characteristics under state law, are provided with an explicit choice regarding how the income of the firm is taxed.<sup>1</sup> For firms engaged in general business activities, the choices under current law are generally the rules contained in subchapters C, K, and S of the Internal Revenue Code. Although incorporated firms are currently not provided with the same choice as unincorporated ones, an unincorporated business with *precisely* the same characteristics as an incorporated firm *is* given that choice. Hence, it seems only a matter of time before all private firms, incorporated and unincorporated, will be afforded the same explicit choice of taxation schemes.<sup>2</sup>

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1. See Regs. §§ 301.7701-1, -2, and -3. The new regulations, which were effective January 1, 1997, were stimulated by state law changes permitting partnerships and other unincorporated organizations to possess business characteristics traditionally associated with corporations. See Notice 95-14, 1995-1 C.B. 297; Rod Garcia & Nancy Loube, LLCs, or How the Government Got to Check-the-Box Classification, 67 Tax Notes 1139 (1995).

2. Public firms are not provided the same choice by reason of § 7704 of the Code. See Regs. § 301.7701-2(b)(7). The proper classification and taxation of public firms is beyond the scope of this article.

This state of affairs is a curious one, given the historical background and substantive rules of subchapters C, K, and S. The origin of subchapters C and K and, specifically, the separate entity taxation of corporations as opposed to the conduit taxation of partnerships, can be traced to some extent to a debate which raged during the last part of the 19th Century and the early part of the 20th Century concerning the nature of corporate and partnership personality.<sup>3</sup> At that time, the “aggregate” versus “entity” controversy, familiar now in the partnership area, applied to both corporations and partnerships. Gradually, the entity theory prevailed for corporations but not for partnerships:

Corporate characteristics of free transferability of interests, continuity of life, limited liability and centralized management . . . emphasized the distinction between the corporation and its shareholders. Corporate liability was not shareholder liability. The life of the corporation was independent of that of its shareholders. . . . This was in contrast to a partner’s relationship to a partnership. Partners were generally actively involved in the partnership’s business, as well as responsible for the partnership debts. Additionally, the life of the partnership was contingent on the life of its members. These factors created a unity between the partner and the partnership. Legal theory, following these basic differences between a corporation and a partnership, veered toward a natural entity theory in the corporate area, but resisted it, at least partially, in the partnership area.<sup>4</sup>

This theory of business organization personality influenced the income tax rules that developed for those organizations. The first income taxes in this country, imposed during the Civil War period, were generally only taxes on individuals. Although certain companies were required to pay tax on amounts paid out as dividends or interest, the same amounts were then deductible from the payee’s tax base.<sup>5</sup> Thus, the original structure could well be viewed as imposing a mere withholding tax on the companies and not a

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3. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 *Ind. L.J.* 53, 57-62 (1990). Much of the following discussion regarding the origins of the corporate income tax are based on Professor Kornhauser’s article.

4. See *id.* at 61.

5. See Act of July 1, 1862, ch. 119, §§ 81-82, 90-91, 12 Stat. 432, 469-71, 473-74 (1862). The taxes were also imposed based upon the specific industry or trade of the business and not its form of organization.

tax independent of the individual income tax.<sup>6</sup> For owners of other firms, both incorporated and unincorporated, a pure conduit approach was specified:

In estimating the annual gains, profits, or income of any person, . . . the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.<sup>7</sup>

Thus, as of the time of the Civil War period, there was no clear indication that corporations should be treated any different from partnerships for income tax purposes.

This attitude changed in 1894 when the income tax was reintroduced.<sup>8</sup> The 1894 law contained both a 2% tax on the income of individuals and a similar tax on the income of all "corporations, companies, or associations . . . but not including partnerships."<sup>9</sup> An individual, however, was entitled to exclude from his or her tax base any dividends received from a corporation which had already paid the 2% tax.<sup>10</sup> This feature, combined with the fact that both taxes were levied at the same rate, also suggested that the corporate tax might be viewed as a mere withholding tax. However, in at least one important respect, the corporate tax was more clearly a separate and independent tax: unlike individuals, who only had to pay tax on income in excess of \$4,000, corporations were not provided with any exemption amount.<sup>11</sup> Thus, the corporate tax was not simply a convenient and administrable way to collect the individual income tax on corporate-source income.

The significance of the separate, entity tax levied on corporations in 1894 was not lost on the legislators at the time. Those who advocated a corporate exemption similar to the one available to individuals objected to the fact that corporate-source income would otherwise be taxed more harshly than the income of partnerships. They viewed the corporation as primarily an aggregate of individuals analogous to a partnership. In contrast, legislators

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6. The Supreme Court was confused regarding the nature of the tax imposed on certain companies, first holding that it was a separate tax, *Barnes v. The Railroads*, 84 U.S. 294, 303 (1872), and then concluding that it was a mere withholding tax and therefore part of the individual income tax system, *United States v. Railroad Co.*, 84 U.S. 322 (1872).

7. Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281-82 (1864).

8. See Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 *Cath. U. L. Rev.* 437, 438 (1995) ("[t]he 1894 Act ... marked the first time in this country's revenue history that the law distinguished corporations from other types of business organizations for tax purposes").

9. Act of Aug. 27, 1894, ch. 349, §§ 27, 32, 28 Stat. 509, 553, 556 (1894).

10. See *id.* § 28, at 554.

11. See *id.* §§ 27, 32, at 553, 556.

who successfully opposed all attempts to adopt a corporate exemption, including some amendments limiting an exemption to small corporations, supported their position by articulating an entity theory for corporations.<sup>12</sup> Consistent with the statute and legislative background, the regulations issued by the Treasury under the 1894 Act made clear that the corporate tax did not apply to partnerships. Instead, partnership income would be taxed under a conduit system:

Partnerships, as such, are not liable to taxation of firm or partnership profits or income, but each individual member of the partnership shall include his share of the partnership profits, gains, or income, in his individual list, where he is required by law to make return of his income for taxation.<sup>13</sup>

The 1894 income tax was later found to be unconstitutional in *Pollock v. Farmers Loan and Trust Co.*<sup>14</sup> Nevertheless, the divergent tax treatment of corporations and partnerships, based in part on the differing theories of their legal personality, was established. The corporate excise tax of 1909, the predecessor to the modern corporate income tax, imposed a 1% tax on net income in excess of \$5,000.<sup>15</sup> Because of constitutional and other reasons, the tax was explicitly limited to corporations and associations; individuals and partnerships engaged in the same business were not subject to the tax.<sup>16</sup> Once again, one of the justifications for this treatment was the "entity" nature of a corporation.<sup>17</sup> Following passage of the Sixteenth Amendment, subsequent tax acts continued the pattern of taxing corporations but not partnerships as separate entities. The only difference was that with the reintroduction of an individual income tax in 1913, Congress provided for various schemes to implement at least partial integration of the corporate and individual income taxes. Integration efforts were eventually ended in 1936.

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12. See Kornhauser, *supra* note 3, at 87-90. There was also concern that corporations, but apparently not other forms of business organizations, were not paying their proper share of taxes. See Hobbs, *supra* note 8, at 445-46.

13. Regulations Relative to the Assessment, Levy and Collection of the Tax on Incomes Under the Provisions of the Act of Congress in Effect August 28, 1894 (December 13, 1894), reproduced in Roger Foster & Everett V. Abbot, *A Treatise on the Federal Income Tax Under the Act of 1894* 484 (1895).

14. 157 U.S. 429 (1895), reh'g granted, 158 U.S. 601 (1895).

15. Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112 (1909).

16. See *id.* *Pollock* had placed into question whether this pre-Sixteenth Amendment tax would be constitutional if applied to individuals. Another reason for limiting the tax to corporations was a desire to regulate businesses organized in corporate form. See Kornhauser, *supra* note 3, at 99.

17. See Kornhauser, *supra* note 3, at 102-05.

In summary, the separate entity taxation scheme of subchapter C and the conduit taxation approach of subchapter K can be traced to some extent to theories relating to the legal personality of corporations and partnerships. Corporations, as entities, were taxed independently from owners; partnerships, as aggregates, were not. And important in deciding whether a business organization constitutes an entity or an aggregate were the characteristics of the organization such as centralized management, continuous life, free transferability of ownership interest, and limited liability.

Other differences in the substantive rules of subchapters C and K bear out this entity/aggregate distinction. For example, contributions to and distributions from a corporation are more likely to be taxable than those to and from a partnership.<sup>18</sup> These results naturally flow from a conception of a corporation, but not a partnership, as an entity separate and distinct from its owners. Similarly, liabilities incurred by a partnership, but not a corporation, are passed through and taken into account in determining the tax consequences of the owners of the firm.<sup>19</sup>

Subchapter S, enacted in 1958 and substantially revised in 1982, constitutes a middle ground between subchapters C and K. It provides a conduit form of taxation for certain businesses organized in corporate form.<sup>20</sup> Nevertheless, perhaps because of its close relationship to subchapter C (a given business may move easily between the C world and the S world) and because it has been applicable only to corporations, subchapter S retains many "entity" tax characteristics. Probably the most important is the refusal to permit corporate-level debt to pass through to the shareholders of an S corporation for income tax purposes.<sup>21</sup> In addition, the contribution and distribution rules for S corporations follow the subchapter C provisions more closely than their subchapter K counterparts.<sup>22</sup> Furthermore, unlike the section 754 election in subchapter K, there is no mechanism in subchapter S for adjusting the inside basis of a firm's assets upon the death of an owner, a transfer of ownership interests, or a distribution from the firm. Finally, S corporations, but not subchapter K firms, can participate in a tax-free reorganization with a C corporation.<sup>23</sup>

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18. Compare IRC § 351 with § 721 and §§ 301, 302, 331, 311, and 336 with §§ 731, 704(c)(1)(B), and 737.

19. See IRC § 752.

20. Former subchapter R, enacted in 1954 and repealed in 1966, did the opposite of subchapter S. It allowed certain unincorporated businesses to elect to be taxed as entities under subchapter C.

21. See IRC § 1366(d).

22. See IRC §§ 351, 311, 336, 1368, 302, and 331.

23. See IRC § 1371(a).



Thus, each set of rules—most clearly in the case of subchapters C and K and less obviously in the case of subchapter S—was designed to apply to a particular business organization form with specific characteristics. Yet, adoption of the check-the-box regulations reflects a policy determination generally to disregard business organization form and characteristics for income tax purposes. Given that, it is difficult to understand why firms are nevertheless allowed a choice regarding how they are taxed and why they are given the particular choices that they are.

If the three sets of rules produced more or less the same tax consequences in most situations, the choice among them might not be especially significant. But that is not the case. In any given situation, subchapters C, K or S might provide an advantageous tax result for particular taxpayers. For example, subchapter C generally offers graduated tax rates for the business income of firms subject to those rules,<sup>24</sup> and there are a host of special tax provisions limited to subchapter C firms.<sup>25</sup> Subchapter K offers the purest form of conduit taxation under which the firm is not taxed and business income and losses are passed through to the owners of the firm. Finally, as just noted, subchapter S offers another form of conduit taxation which, nevertheless, incorporates certain significant entity tax characteristics. As a result, subchapter S is in many cases less advantageous than subchapter K but in certain cases, more advantageous.<sup>26</sup>

The elective tax treatment of private firms under current law undermines both equity and efficiency objectives for the income tax. Although in theory, similarly situated businesses have the same opportunity to be treated in the same tax-advantageous manner under current law, the practical reality is probably to the contrary, due to disparities in the quality

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24. See IRC § 11(b). If the shareholder tax of a subchapter C firm is deferred or reduced sufficiently or eliminated altogether, the graduated rate structure can mean that business income is taxed more favorably under subchapter C than under either subchapters K or S. Subchapter C may also be an attractive choice for those private firms which envision going public someday. Cf. Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 *UCLA L. Rev.* 1737, 1749-50 (1994).

25. See, e.g., IRC §§ 465(a)(1)(B) and 469(a)(2)(B) (at risk and passive activity loss rules generally applicable only to certain closely held C corporations). On the other hand, these rules do apply to the individuals who are either partners or S corporation shareholders. See IRC §§ 465(a)(1)(A) and 469(a)(2)(A).

26. In addition to the differences previously noted in the text, there are two other significant ways subchapters K and S depart from one another. Subchapter K but not subchapter S firms may specially allocate their tax items among their owners. Compare IRC § 704(a) and (b) with IRC § 1377(a). On the other hand, there exists in subchapter K a series of complicated rules designed to prevent tax advantages in selected situations. See, e.g., IRC §§ 704(c), 707(a)(2) and (b), 724, 731(c), 735, 737, and 751. Subchapter S corporations are not subject to those rules although they are subject to the collapsible corporation provisions of § 341. See IRC § 1371(a).

of advice the businesses receive. By permitting such disparate choices without any apparent underlying conceptual foundation, current law has simply provided a tax benefit for the well-advised and a trap for the ill-advised. There is no particular policy reason why the taxation of private business firms should result in the minimization of tax liabilities for only the well-advised.<sup>27</sup> Moreover, current law violates vertical equity norms. By giving business owners a range of tax liabilities to choose from, current law by definition cannot impose the "proper" level of tax on them based upon vertical equity principles.

Inefficiency arises because of the increased transactions costs necessitated by current law. To minimize tax burdens, businesses must be prepared to examine the consequences of three possible operating rule structures on their anticipated business activities and to comply with the rules selected. The IRS must administer and give oversight to the three different structures. Further, the planning, compliance, and administration costs are ongoing in that businesses may have the opportunity to change their choice of rule structure as their business activities evolve. Moreover, aside from increasing transactions costs, current law's favorable tax treatment of private business firms distorts economic decisions for those businesses on the individual/firm and public firm/private firm boundaries, thereby potentially causing deadweight losses. Finally, to the extent simplification is a tax policy goal independent of equity and efficiency concerns, it is certainly not enhanced by current law.

In conclusion, the current system of taxing the income of private business firms has evolved into one which is inconsistent with its historical roots and violates important tax policy objectives. The balance of this article describes an alternative system for such taxation.

### III. TAXATION OF PRIVATE FIRMS AS CONDUITS

A threshold question is whether a private firm should be treated as a "conduit" or an "entity" for tax purposes. Under conduit taxation, the firm is not treated as a taxpayer separate and apart from its owners. Rather, the firm is transparent for tax purposes; its various tax items pass through to the owners of the firm, the real (and only) taxpayers in interest. Under current law, the purest form of conduit taxation is found in the partnership tax rules of subchapter K.

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27. See William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. Colo. L. Rev. 1001, 1012-13 (1995).

In contrast, under entity taxation, the firm is treated as a taxable entity in its own right. Although entity taxation is often associated with the "double tax" system of subchapter C, it need not have that consequence. For example, in 1992, the Treasury Department recommended exploration of an approach, termed the Comprehensive Business Income Tax (CBIT), which would subject the income of all business entities (except for extremely small ones in terms of gross receipts), including sole proprietorships, partnerships, corporations, and firms organized in other business forms, to a single, comprehensive entity-level tax, with generally no further income tax consequences at the owner level.<sup>28</sup> Other, similar proposals have been advanced over the years.<sup>29</sup> The Treasury estimated that CBIT would produce greater welfare gains than any other form of corporate integration, including Treasury's version of partnership-style integration.<sup>30</sup>

The following sections explore some of the pros and cons of conduit and entity taxation.<sup>31</sup> Although the choice is a close one, the conclusion is that all private firms should be taxed in accordance with a conduit approach.

#### A. *The Basic Case for Conduit Taxation*

The most basic form of business is the sole proprietorship. Sole proprietors have historically been taxed directly on their proprietorship income as it arises and been entitled to deduct currently any losses of the enterprise as they arise. The business itself has not been subject to a separate federal income tax. It would theoretically be possible to treat a proprietorship as a taxpayer separate from its proprietor, but such a system would be very problematic, depending upon the applicable tax rate structure. For example, if all proprietorships were treated as taxpayers subject to a flat 30% income tax rate, then individuals in marginal tax brackets higher than 30% might be encouraged to redesign their economic arrangements to generate proprietorship income for themselves rather than wages or other income.<sup>32</sup> Meanwhile,

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28. U.S. Dep't of Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992) [hereinafter *Treasury Integration Report*].

29. See Mortimer M. Caplin, *Income Tax Pressures on the Form of Business Organization: Is It Time for a "Doing Business" Tax?*, 47 *Va. L. Rev.* 249, 261 (1961) (suggesting adoption of an entity-level tax on the profits of virtually all business enterprises, whether incorporated or not, combined with a lowering of dividend taxes to alleviate concerns of double taxation).

30. See *Treasury Integration Report*, *supra* note 28, at 134 (Table 13.8), 139-141.

31. A third option is a hybrid approach in which low-rate taxes at *both* the firm *and* owner levels equate to a single tax on business income. See George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 *Tax L. Rev.* 431, 480-501 (1992).

32. This discussion ignores the potentially significant effect of employment and state and local taxes on the choice of compensation arrangement.

proprietors in marginal tax brackets less than 30% might be encouraged to employ the opposite strategy. For instance, they might increase the level of deductible salary payments paid by their proprietorship to themselves. Given the absence of arm's length dealing in a proprietorship, it would presumably be extremely difficult for the IRS to monitor and prevent purely tax-motivated arrangements of this sort.

Taxing the proprietorship's income in a progressive manner would not improve matters because there still would not be any necessary correlation between the proprietorship's tax rate and the proprietor's ability to pay. The proprietor may well have income or losses from other sources. It is for this same reason that the graduated tax rate structure under which many corporations are taxed today does not carry out any vertical equity objective.<sup>33</sup>

Assuming proprietors are to continue to be taxed directly on their business income and losses, then it follows that businesses with more than one owner should likewise be taxed as conduits. If the proprietorship is not treated as a separate taxpayer, it is difficult to see why, say, a two-person general partnership should be so treated. Further analogies then might suggest that *no* business firm should be separately taxed. As an economic matter, if proprietors are taxed directly on their proprietorship income but partnerships (and not the partners) are taxed on the partnership income, then the tax system will have created an undesirable barrier against or inducement in favor of the pooling of resources via a partnership.

True, the state law characteristics of a proprietorship may be different from those of many other business forms. Unlike a proprietorship, other forms of business organization are treated for an increasing number of state law purposes as legal entities separate from their owners. For example, the recently Revised Uniform Partnership Act (RUPA) generally endorses an entity theory of a partnership, and it therefore provides that the withdrawal of a partner from a partnership causes the dissolution of the partnership only in limited circumstances.<sup>34</sup> RUPA also makes clearer that a partner is not

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33. See IRC § 11(b).

34. See Revised Unif. Partnership Act § 801 (amended 1996), 6 U.L.A. 87 (Supp. 1997) [hereinafter RUPA]. See, generally, RUPA, § 201 ("[a] partnership is an entity distinct from its partners"), comment to § 201 ("RUPA embraces the entity theory of the partnership"). As of the end of 1995, seven states had adopted the RUPA. Although the Uniform Partnership Act (UPA) included certain entity-type characteristics for partnerships, particularly relating to the rights of the entity to own and convey property (see U.P.A., §§ 8, 10, 25, and 26), the Act generally favored an aggregate interpretation of the partnership. Examples of the UPA's aggregate approach included its provisions relating to the joint and several liability of partners for partnership debts, the rights of all partners to manage and conduct the business of the partnership, and the dissolution of a partnership upon any partner's ceasing to be associated with the business. See U.P.A., §§ 15, 18(e), and 29.

co-owner of the underlying property of the partnership; rather, the only transferable interest of a partner in the partnership is the right to share in profits and losses and to receive distributions.<sup>35</sup> Other forms of doing business, such as limited partnerships, LLCs, limited liability partnerships (LLPs), limited liability limited partnerships (LLLLPs), and of course, corporations, justify an entity interpretation of the business because, among other things, they generally insulate the owners from the entity's liabilities. Further, the check-the-box regulations may accelerate these state law trends, with future approval by the states of noncorporate business forms having more and more entity characteristics.

But the clear message of the check-the-box regulations is that state law differences among private business entities should be ignored in deciding how they are taxed.<sup>36</sup> Thus, the decision of whether a private firm should be taxed like a conduit or an entity should seemingly be based on tax policy considerations such as equity, efficiency, and simplicity. As just discussed, the strongest tax policy argument in favor of the conduit approach is that people pay taxes, not entities, and that people should pay income taxes in accordance with their abilities to pay. The use of an entity to generate income should not interfere with that basic objective. Hence, the entity should be disregarded for tax purposes and the income of the entity should be taxed directly to its owners. Entity losses and other tax items should similarly be passed through directly to the owners, to be netted with the owners' items from other sources. Another tax policy argument favoring the conduit approach is that it avoids distorting the choice of business form, given how proprietorships are taxed.

But these arguments may only be valid for a theoretically ideal form of conduit taxation. For reasons detailed in the next section, if a conduit approach is considered in actual practice, it may be that the approach does not accomplish either tax policy objective very well while, at the same time, spawning significant transactions costs.

### *B. The Fundamental Difficulty of Conduit Taxation and the Case for Entity Taxation*

The same theoretical reasons in support of conduit taxation would lead one to conclude that entity taxation is unacceptable. For example, if we take as a given that people and not entities pay taxes, and that people should pay income taxes in accordance with their ability to pay, then it would seem

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35. See RUPA, *supra* note 34, §§ 501, 502.

36. Cf. William A. Klein, *Income Taxation and Legal Entities*, 20 *UCLA L. Rev.* 13, 15 (1972) (argued that correlation between taxation method and relationship under state law of an entity to its owner has "relatively limited explanatory value").

odd and inconsistent with those premises to impose a separate income tax on the business entity itself. If the owners of the firm indirectly bear the burden of the entity-level income tax, then the proper rate for the tax should presumably be tied to their ability to pay. But how should the entity tax rate be determined where the ability to pay of the owners is different from one another?

The case for entity taxation, however, is essentially a negative one. Specifically, if it is not possible to design a workable conduit tax system which is broadly applicable to most private business firms and is consistent with general income tax principles, then an entity tax approach may be worth a second look. To illustrate some of the difficulties in implementing conduit taxation, the balance of the discussion in this part III of the article will focus mainly on the partnership tax rules—subchapter K—because they represent the most refined example of conduit taxation in existence.

Under conduit taxation, if a business firm earns \$300 in taxable profits in a given year, a total of \$300 of taxable income must be currently included in the tax base of the owners of the firm. But how much should be included in whose base? The difficulty in answering that question is the fundamental problem of any conduit system.

The source of the difficulty is the fact that income and other items realized by many business entities are treated under state law as belonging to the entity and not to the owners. The receipt by the owners of the entity's income, for example, may arise only upon a distribution from the entity. Yet consistent with basic income tax principles, tax reporting of the income cannot await a distribution. Someone must include it in that person's tax base when the income arises. Thus, if there is no distribution of the income by the entity, there must nevertheless be a current allocation of the income among the owners to permit them to report currently their share of it.

How is the allocation of income and other items determined for tax purposes under current law? In general, current law permits the allocation of tax items to be made with great flexibility. Indeed, the general rule for a partnership allows the determination to be made by the partners in their partnership agreement.<sup>37</sup> Hence, by private agreement, the partners might decide to allocate the income of the partnership equally among themselves, or to allocate all of the income to only one partner, or to provide for any other sharing arrangement. Assuming the allocation has "substantial economic effect," a concept discussed below, the only limitation is that all of the partnership taxable income must be reported by some partner or partners for the year. The partners also may allocate to themselves different shares of each partnership tax item in any given year and may vary the allocation of each

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37. See IRC § 704(a).

such item from year to year. The tax sharing rules are flexible to permit consistency with flexible economic sharing arrangements. Indeed, the tax shares can even be determined with hindsight, that is, after the end of the year in question, to accommodate the often hindsight determinations of economic shares.

But flexible tax sharing rules also may be used simply to minimize the collective tax liabilities of the partners, to the detriment of the Treasury and all other taxpayers. By allocating items to the partner who is in a position to utilize them most favorably for tax purposes, the partners can put their respective tax advantages to best use and share in the resulting tax savings. As Professor Surrey and others stated with some concern when special allocations were first permitted in 1954:

. . . parties, perhaps for the first time in the history of the tax laws, will be permitted to agree on the incidence of tax; to agree as to which of several co-earners of income shall be entitled to specific items of income and of income tax deduction and credits. Capital gains could be allocated on one basis, dividends on another, tax-free interest in accordance with still another ratio. By agreement, operating expenses, depletion or depreciation could all be allocated in differing proportions.

The ability to contract with respect to specific items of income, and particularly with respect to specific items of deduction and credit, would give the ingenious businessman and his lawyers the utmost flexibility in devising a variety of novel and unique business arrangements.<sup>38</sup>

Is there anything wrong with the partners minimizing their collective tax liabilities in that manner? The objection, often unstated, is the concern that the partnership vehicle permits the taxpayer to obtain a tax result more favorable than the one that would have arisen had the taxpayer simply owned a share of the business's assets directly.<sup>39</sup> Thus, assume a taxpayer would have had \$100 of taxable income from a share of certain real estate assets had the taxpayer owned that share directly. Assume that with \$100 of income for the year from the asset, a portion of the taxpayer's net operating loss

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38. See J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen & William C. Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 *Colum. L. Rev.* 1183, 1187-88 (1954).

39. Cf. Regs. § 1.701-2(c)(1) (potential applicability of partnership anti-abuse regulation if "[t]he present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly").

carryover would have expired unused. To preserve the integrity of the taxable unit, the tax laws presumably should not permit the taxpayer to join up with two others, obtain a special \$300 allocation of taxable income for the year (representing the taxpayer's share of income from the asset and the shares of the taxpayer's partners), offset it with a disproportionately small allocation of income in future years, and thereby make greater use of the carryover than would otherwise have been possible. A tax system allowing that result neither protects vertical equity objectives nor is neutral in the choice of business form, the two tax policy advantages initially identified for the conduit approach.

Can such tax advantages be prevented? The statutory standard is to require that an allocation have "substantial economic effect" in order to be respected. If substantial economic effect is absent, the statute authorizes a reallocation of all items in accordance with the partner's normative or economic share of the item in question.<sup>40</sup> The regulations interpret "substantial economic effect" as encompassing two requirements: the allocation must have "economic effect" and must pass a "substantiality" test.<sup>41</sup> As we will see, however, neither test is particularly effective at preventing purely tax-motivated allocation arrangements under a conduit method of taxation.

1. *Economic Effect.*—The basic principle of the "economic effect" test is that tax items may be allocated to partners only in the same manner in which they share the economic burdens and benefits relating to those items.<sup>42</sup> In other words, a partner may be allocated a \$100 share of the partnership's taxable income only if the partner is also allocated \$100 of the partnership's economic benefit relating to the taxable income. The partner may be allocated a \$100 tax loss by the partnership only if the partner must suffer the \$100 economic detriment relating to that loss.

As a technical matter, the regulations implement this principle by focusing on the book capital accounts of the individual partners, the accounts which describe the economic relationship of the partners between and among themselves and specify what their respective rights are upon a liquidation of

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40. See IRC § 704(b).

41. See Regs. § 1.704-1(b)(2)(i).

42. See Regs. § 1.704-1(b)(2)(ii)(a) (to be valid, a tax allocation "must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden"); cf. Regs. § 1.701-2(a)(3) ("... the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income . . .").



the firm. To have economic effect, the capital accounts must be maintained in a certain way, be adjusted in the same manner as the tax allocation, and be respected by the partners in determining their economic interests in the partnership upon liquidation.<sup>43</sup> The rules are lengthy and complex, and the burden on those taxpayers who attempt to comply with them is considerable,<sup>44</sup> but the basic idea is simple: if tax allocations follow comparable adjustments to the partners' capital accounts, which are economic accounts, and if those adjustments affect account balances which ultimately have real economic significance to the partners, then the tax allocation will be consistent with the economic share.

Pairing tax consequences with their economic counterparts is a common method of trying to prevent tax avoidance because ordinarily, assuming a tax rate of less than 100%, the underlying economic consequence of an action outweighs the tax effect of that action. For example, one would not expect a taxpayer to make a cash outlay of \$100 merely to obtain a tax deduction equal to that amount because the tax savings from the deduction will be less than the amount of the cash outlay. Thus, if the availability of the tax deduction were *conditioned on* the taxpayer's actual incurrence of the \$100 expense, one might have confidence that the deductions were all legitimate. In short, the concept of "economic effect" might be a promising method of monitoring and preventing purely tax-motivated allocations.

Unfortunately, the economic effect requirement fails to achieve its intended purpose and does not preclude purely tax-motivated allocations. One reason for this failure is that capital account balances only supply some indication of the economic rights and obligations of the partners upon a hypothetical liquidation in the current year of either the partner's interest in the partnership or the partnership itself. Yet in the vast majority of cases, neither of those two events is specifically contemplated by the partners, so that a capital account adjustment resulting in a currently negative or positive account balance may not be particularly meaningful. Rather, in most cases, the economic outlook of the partners goes far beyond such a hypothetical current liquidation to encompass events that may occur well in the future. In

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43. See Regs. §§ 1.704-1(b)(2)(ii)(b), -1(b)(2)(iv)(b).

44. See Alan Gunn, *Partnership Income Taxation* 44 (2d ed. 1995) (the allocation rules are "so difficult that only a handful of partnership-tax specialists in large firms will be able to apply [them]"); Stephen Utz, *Federal Income Taxation of Partners and Partnerships* 108 (3d ed. 1995) [hereinafter Utz-Federal] (describing regulations as "monstrously complex"); see also Michael J. Close & Dan A. Kusnetz, *The Final Section 704(b) Regulations: Special Allocations Reach New Heights of Complexity*, 40 *Tax Law.* 307, 336 (1987); Lawrence Lokken, *Partnership Allocations*, 41 *Tax L. Rev.* 547, 621 (1986) ("The . . . regulations under section 704(b) are a creation of prodigious complexity . . . . The complexity . . . makes the regulations essentially impenetrable (sic) to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject.")

short, capital accounts provide at best a mere static snapshot of the economic situation of the partners whereas their real situation may well be based on dynamic, multi-year expectations.<sup>45</sup>

To illustrate, suppose general partnership AB makes a special allocation of a \$200 tax loss in year 1 to partner A. In that situation, the economic effect test simply requires that the special allocation be accompanied by an allocation to A's capital account of a \$200 economic burden in year 1. But the allocation of an economic burden to A has significance only if there is a liquidation of A's interest at the end of year 1, an event not likely to occur and not expected by the parties. The economic effect test does *not* require A to actually outlay a \$200 investment in year 1 in order to obtain the \$200 tax loss. Indeed, the other partner, B, may have made all or most of the actual investment, yet A may be allocated the entire tax loss. Nothing in the Treasury's economic effect regulations prohibits that outcome.<sup>46</sup> To be sure, if there were a liquidation immediately after year 1, then based on the capital account adjustment, A's economic share in the venture would be reduced by \$200. Again, however, liquidation is not contemplated by the parties so that possibility may not be of significance. In short, the economic effect requirement attempts to match the allocation and actual claiming of a tax item with the economic burden or benefit associated with that item, yet it completely ignores the proximity or remoteness of the burden or benefit and, therefore, whether it will in fact ever be realized.<sup>47</sup> In that sense, the regulatory mandate constitutes a highly complex and extremely burdensome set of paper entries.

The regulations basically concede the "paper entry" aspect of the economic effect requirement. Under the "transitory" leg of the substantiality test, which (as described later) is an independent basis for invalidating an

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45. Cf. Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 *Tax L. Rev.* 1, 11-14 (1990); Alan Gunn, *The Character of a Partner's Distributive Share Under the "Substantial Economic Effect" Regulations*, 40 *Tax Law.* 121, 124-25 (1986); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 *Va. L. Rev.* 1039, 1059 n.85 (1980); Utz-Federal, *supra* note 44, at 118; Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 *Tax Law.* 693, 700-01 (1990).

46. If A's only investment in the partnership were less than \$200 and the partnership had no debt, then A's loss for the year would be limited to the amount of his or her investment. IRC § 704(d). But if the loss were generated by partnership debt and enough of the debt were allocated to A, which would almost always be the case, there is nothing in the economic effect rules to prohibit A's claim of the \$200 loss.

47. See Utz-Federal, *supra* note 44, at 117. What the parties *may* contemplate, and what in fact may transpire, is a prompt special allocation of income to A in year 2 to make up for the special loss allocation in year 1. The offsetting allocation immediately cancels out the hypothetical economic burden assumed by A as a result of the year 1 allocation. Thus, in any year after year 2, A's economic burden would have vanished, with the allocation of such burden to A in year 1 having been a mere paper entry.

allocation, neither a current nor future allocation will be respected if at the time they are agreed to, there is a strong likelihood that they will offset one another yet will reduce collective tax liabilities.<sup>48</sup> But if adjustments to capital accounts have real economic significance when they are made, then there is no particular reason why the Treasury should be concerned about the possibility of there being offsetting future adjustments. The fact that the Treasury is rightly concerned about that possibility is indicative of the inconsequential nature of the initial capital account adjustment and, therefore, the entire economic effect test.

In addition, the economic effect test is completely ineffective at preventing the tax-motivated allocation of tax items which do not have any economic counterpart borne by any partner. Initial examples of such tax items include certain tax credits, depreciation and other noneconomic deductions, and deductions attributable to nonrecourse indebtedness incurred by the partnership. If a \$100 tax depreciation deduction of a partnership has no economic corollary (because there is no cash outlay of that amount and the property being depreciated has in fact retained its value), to whom should the deduction be allocated under the economic effect test?

Other even more pervasive examples of tax items without economic counterparts are tax deductions attributable to any form of entity debt if the owners, such as limited partners, LLC members, corporate shareholders, or any partners of an LLP or an LLLP, are shielded from personal liability for repayment of the debt.<sup>49</sup> In those circumstances, it may not be possible to award tax losses only to those bearing the economic risk of loss because no owner may bear that economic risk. Lastly, certain tax items, such as capital gain or tax-exempt income, have an economic counterpart but also introduce matters of significance only for tax purposes. A dollar's worth of capital gain and ordinary income may look the same from the perspective of a capital account adjustment, but they may have very real differences from a tax standpoint.

For all of these types of tax items, then, there may be no economic touchstone on which to determine the proper allocable share of the item belonging to the partner. The solution of matching tax allocation with economic consequence does not work if a tax item is without any corresponding economic effect or is important only because of some uniquely tax-related reason.

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48. See Regs. § 1.704-1(b)(2)(iii)(c).

49. See Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 *Am. J. Tax Pol'y* 13, 58 (1995) (“[t]he economic risk of loss concept is meaningless with respect to most LLC liabilities, since no member is personally liable”).

2. *Substantiality*.—Recognizing the inadequacy of the capital account approach and the economic effect test, the regulations impose a second, independent requirement for insulating a tax allocation from challenge. This requirement, termed “substantiality” in a curious use of a word, focuses on the tax minimization effect of the allocation.<sup>50</sup> In other words, even if a tax allocation conforms to the capital account adjustments of the partners in the manner specified by the economic effect requirement, the allocation may still be invalid if its effect is to minimize tax liabilities.

The substantiality requirement is manifested in several different ways in the regulations but the strongest version focuses on the *after-tax economic consequences* of the proposed allocation to the partners. Under this version of the test, substantiality is flunked and an allocation is invalid for tax purposes if, after the tax effects of the allocation are taken into account, no partner is worse off and at least one partner is better off (both determined from a present value standpoint) than the results had no special allocation taken place.<sup>51</sup> It is, in effect, a test of “tax efficiency,” with a Pareto improvement in this case being an arrangement indicative of tax avoidance and therefore impermissible. An obvious concern with such a test is the potential invalidation of an economically efficient allocation which just happens to coincide with the tax efficient one. But the regulations apparently set that concern aside as perhaps the price that must be paid to prevent tax avoidance.

The substantiality test is sometimes difficult to apply in practice. For example, suppose special allocations span a number of years or encompass a number of different tax items in a given year, with all such allocations involving, perhaps, different sharing arrangements. Which group of allocations should be taken into account in measuring the after-tax economic consequences mandated by the substantiality test? The substantiality test generally requires consideration of more than one allocation, yet it provides little indication regarding exactly *which* allocations must be considered.<sup>52</sup>

The after-tax economic consequences of allocations may also not be readily ascertainable. Suppose, for example, a partnership claims certain tax depreciation deductions with respect to an investment in a building and

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50. See Regs. § 1.704-1(b)(2)(iii).

51. See Regs. § 1.704-1(b)(2)(iii)(a).

52. For certain incarnations of the substantiality test, but apparently not for the strongest version of it, the regulations apply a five-year cut-off rule. See Regs. § 1.704-1(b)(2)(iii)(c) (flush language). Hence, offsetting allocations occurring more than five years after the initial allocation under scrutiny need not be taken into account in determining whether substantiality is met. The arbitrary five-year rule applies even though the fact of the offsetting allocation is reasonably fixed and certain at the time of the initial allocation. See Regs. § 1.704-1(b)(5), ex. (2).

disproportionately allocates the deductions to one partner. Suppose the same partner is allocated any tax gains resulting from a disposition of the building up to the amount of depreciation allocated to such partner. Under the strongest version of the substantiality test, it might be argued that the partner has obtained an after-tax economic benefit from the allocation if the building is reasonably expected to hold its value over the period of the allocations. In that case, the partner will likely receive an economic gain to offset the initial allocation of economic cost, and will obtain the tax advantage of the early deductions.<sup>53</sup> But such a rule presumably would not be administrable—it would require a case-by-case analysis of property values to know whether a particular allocation should be respected or not. Hence, the current regulations indulge in an assumption—surely false in many cases—that the value of the building declines each year by the amount of its book depreciation (the “value-equals-basis” rule). Therefore, the partner in the example is deemed to have suffered an economic detriment greater than any tax savings as a result of the allocations, and the substantiality test is thus satisfied.<sup>54</sup> Although the regulatory assumption may be the only feasible rule to use, it certainly highlights the artificiality and ineffectiveness of the substantiality requirement in this common circumstance.

Aside from these practical dilemmas, there is a more fundamental concern with the substantiality test. As noted, the strongest version of the test (as well as both of the weaker versions) requires a comparison: are the after-tax consequences of the partners from the allocation better or worse than from some other? But *which* other? Surely, it cannot be *any* other allocation, for it must always be possible to hypothesize an allocation which is economically no different from the one under scrutiny, yet is not as favorable from a tax standpoint. In other words, presumably the objective of the law is not to force tax *maximization* upon the partners, i.e., the *least* “efficient” outcome from a tax standpoint. Rather, the concept would seem to require identification of some normative method of allocating the particular item in question, and a comparison with the tax consequences of that normative method. Yet in many cases, the proper normative method of allocating an

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53. One assumes that normal arm's length bargaining will protect the other partners from suffering a net after-tax detriment from the special allocation. So long as the tax disadvantage to those partners due to their loss of the early deductions is less than the tax benefit to the partner who is allocated a disproportionately large share of those deductions, the parties can split the net tax savings with the only loser being the Treasury and taxpayers generally.

54. See Regs. §§ 1.704-1(b)(2)(iii)(c) (flush language), -1(b)(5), ex. (1)(xi). The assumed decline in value of the building means that there will be no offsetting gain belonging to the partner upon disposition of the property.

item—presumably the economic allocation—may not be known or knowable.<sup>55</sup>

In summary, substantiality seems like a promising test for preventing tax avoidance but it cannot work for much the same reason economic effect does not work. Both tests require knowledge of the owners' economic shares of the various burdens and benefits of the entity. But where those burdens and benefits are retained by the entity and not distributed to or assumed by the owners directly, there may be no feasible method of ascertaining what the economic shares are.

3. *Subjective Purpose.*—In part in recognition of the inadequacy of both the economic effect and substantiality tests, the Treasury recently promulgated a general “anti-abuse” regulation in the partnership area. The regulation expressly grants the Commissioner authority to recast a partnership transaction if a principal purpose of the transaction is to reduce substantially the present value of the partners' aggregate federal income tax liability in a manner that is inconsistent with the intent of subchapter K.<sup>56</sup> The recharacterization may take place “even though the transaction may fall within the literal words of a particular statutory or regulatory provision.”<sup>57</sup> Thus, even if an allocation complies with the complex and extensive regulatory requirements for special allocations and passes both the economic effect and substantiality tests, it might still be invalidated under authority of the new Treasury rule.<sup>58</sup>

Despite the formidable tone of this new regulation, it likely will not prove to be an effective tool in preventing the tax advantages available from special allocations. For one thing, as ultimately promulgated, the regulation takes a liberal, “hands-off” attitude towards special allocations. For example, it explicitly blesses rules adopted for “administrative convenience,” such as

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55. See Gunn, *supra* note 44, at 53-54; Close & Kusnetz, *supra* note 44, at 321. The regulations require comparison with a hypothetical situation in which the allocation under scrutiny is not included in the partnership agreement. See Regs. § 1.704-1(b)(2)(iii)(a)(1) and (2), (b)(1) and (2), and (c)(1) and (2). Obviously, that instruction provides little guidance regarding the proper normative share of the partners.

56. See Regs. § 1.701-2(b).

57. See *id.*

58. See Regs. §§ 1.701-2(c)(5) (allocations complying with the literal language of the regulations are nevertheless subject to scrutiny under the anti-abuse regulations if the results of the allocations are “inconsistent with the purpose of section 704(b) and those regulations”), -2(b)(4) (one weapon of Commissioner in implementing anti-abuse regulations is to reallocate partnership items).

the value-equals-basis rule, which are key to insulating certain allocation arrangements from IRS challenge.<sup>59</sup>

Even if that explicit blessing were removed, however, the basic design of the anti-abuse regulation undermines its effectiveness. For example, by focusing on whether or not there has been a substantial reduction in the present value of aggregate tax liabilities, the regulation encounters the same difficulty facing the substantiality test: the “as compared to what” inquiry. Indeed, the answer to that question provided by the new regulation is even less satisfactory than the one provided in the substantiality test. In substantiality, the comparison is with a result produced by a normative, economic sharing of the item in question, something, unfortunately, that may not be known in certain cases. In the new regulation, the answer is to compare with an outcome consistent with “the intent of subchapter K,” an even less well-defined standard.

Further, the regulation is only operative if a subjective intent test is satisfied. “A principal purpose of the transaction” must be to reduce tax liabilities in the forbidden way. Aside from the practical difficulty of knowing whose purpose must be determined and how it should be ascertained, this aspect of the regulation raises the normative question of why tax results should turn on one’s state of mind in the first place.<sup>60</sup> If the partnership tax rules somehow permit tax outcomes that the Treasury considers inappropriate, the solution should be to fix the rule rather than simply to prejudice those taxpayers who take advantage of the rule with the wrong mindset.

4. *Would Some Other Test Be Effective?*—As dismal as the current Treasury regulations are in this area, the problem lies not with them. Rather, the problem is that the regulations are trying to achieve something which cannot be done. As detailed above, the conduit model requires the existence of an economic baseline against which a tax allocation can be tested. Yet so

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59. See Regs. § 1.701-2(a)(3), -2(d), ex. (6) (application of value-equals-basis rule respected by anti-abuse regulation), -2(d), ex. (5) (special allocation scrutinized by anti-abuse regulation but respected).

60. See American Law Institute, *Federal Income Tax Project—Subchapter K—Proposals on the Taxation of Partners* 245 (1984) [hereinafter ALI 1984 Subchapter K Proposals] (arguing against subjective intent test in determining validity of tax allocation); Walter J. Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. Chi. L. Rev. 485, 515 (1967) (“If tax-reducing actions are to pass muster but tax avoidance actions are to be penalized, some way of distinguishing between the two must be located. The trouble is that, as a mental phenomenon, a desire to minimize taxes does not differ from a desire to avoid taxes”); Edwin S. Cohen, *Taxing the State of Mind*, *Tax Executive*, Apr. 1960, at 200, 218 (“to [make tax consequences] depend upon selecting and weighing the motives or state of mind which prompted his action is a far more complex assignment, and one which I believe we should endeavor to avoid”).

long as there is state law separation between the entity and the owners—that is, the owners do *not*, in fact, own the assets directly but instead only own interests in the firm which owns the assets—the economic baseline against which the tax allocation needs to be compared is necessarily missing. For example, we simply don't know how the partners would have shared undistributed income earned by a firm had there, in fact, been a distribution of that income in the year it was earned. Indeed, in many cases, the partners themselves don't even know how they would have shared the income, because their “deal” extends far beyond the economic outcome of the first year. But without that piece of information, it is not possible to fashion a workable rule that can ferret out purely tax-advantaged allocation arrangements under a conduit model of taxation.<sup>61</sup>

5. *Summary.*—To summarize the argument up to this point, this article has contended that as a theoretical matter, the conduit method of taxing the income of private business firms is appealing because it can protect vertical equity norms and minimize distortions in the choice of business form. The practical reality, however, is that the conduit model may not accomplish either objective very well while imposing extremely high transactions costs on both taxpayers and the IRS.

The central flaw of the conduit model is its inability to provide assurance that the proper *amount* of business income and loss for any given year is allocated and taxed to the proper owner. Under the conduit model, allocations of the firm's tax items have no grounding in economic substance due to the absence of an economic baseline against which the allocation can be tested. In addition, the validity of allocations cannot even be tied to matters of legal form because it is the firm, and not the owners, that maintains legal ownership of the items in question. As a result, the conduit approach is unable to protect vertical equity norms; that objective may be thwarted, for example, by allocating to a high-bracket owner a disproportionately small share of the firm's income for a given year. Further, the choice of business form is distorted by the existence of tax advantages available only to businesses with more than one owner which are taxed as conduits. Although the law has certainly evolved well beyond its state in 1954, Professor Surrey's concerns at that time with the potential flexibility of special allocations still seem to be appropriate.<sup>62</sup>

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61. See Gergen, *supra* note 45, at 10-11 (“[q]uite simply, there is no dependable way to distinguish tax motivated allocations from allocations with an economic basis”); cf. Gunn, *supra* note 44, at 53-54.

62. See *supra* note 38 and accompanying text.



### C. Which Approach Would Be More Administrable?

The discussion thus far would seem to have exposed major flaws in *both* conduit *and* entity taxation. Although the latter would tax the business income at the wrong *rate*, the former cannot provide assurance that the business tax *base* is taxed to the right taxpayer. So which approach is preferable?

There is no easy answer to that question. Concerns about the ease with which the IRS can administer the rules and taxpayers can comply with them, however, should obviously play a role in deciding the preferred approach. Otherwise, any rules which are developed risk being a mere facade, a nice theoretical way of imposing taxes on business income that is not matched by real world consequences to most taxpayers. Administrability concerns are particularly significant given the applicability of the rules to taxpayers who are in diverse business arrangements and who may have widely differing levels of sophistication and tolerances for complexity.

The conduit tax system epitomized by subchapter K is notoriously difficult to comprehend and apply. Many analysts have suggested that there may be widespread disregard of one or more of the existing rules because of the inability of firms and their advisors to apply them correctly and of the IRS to administer them. Indeed, back in 1986—which might properly be described as a time when complexity in subchapter K was still in a state of infancy—one tax expert estimated a mere 2-1/2% compliance rate with one particular partnership provision.<sup>63</sup> More recently, another distinguished tax

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63. Hearings Before the Subcommittee on Select Revenue Measures of the U.S. House Committee on Ways & Means on Issues Relating to Passthrough Entities, 99th Cong., 2d Sess. 56 (1986) [hereinafter Hearings] (statement of Joel Rabinovitz) (§ 751(b) is probably overlooked in 90% of the cases in which it applies, is ignored in another 5% of the cases because the cost of compliance would be so high, and is misapplied by the IRS in another 2-1/2% of the cases). See also Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 *Tax Law.* 827, 829 n.17 (1995) (describing how most taxpayers and their advisors “employ a ‘common sense’ approach to the tax law (i.e., it is cheaper to guess the right answer than to research it thoroughly; it is easier to take an aggressive reporting position than it is to plan prophylactically; it is simpler to make a ‘reasonable’ estimate than to compile detailed records of substantiation)”; Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 *Tax L. Rev.* 105, 107-08 (1991) (subchapter K “has become one of the most inaccessible and burdensome features of the entire tax system”); Burke, *supra* note 49, at 57 (“[i]t is already widely perceived that many small (and even some large) partnerships fail to comply strictly with the detailed requirements of Subchapter K”); Pamela Olson, *Some Thoughts on Anti-Abuse Rules*, 48 *Tax Law.* 817, 824 (1995); Joseph A. Snoe, *Economic Reality or Regulatory Game Playing?: The Too Many Fictions of the § 752 Liability Allocation Regulations*, 24 *Seton Hall L. Rev.* 1887, 1888-90 (1994).

In the allocation area, noncompliance might be broken down into at least three categories: failure to establish and utilize mandated procedures (for example, failure to

expert, a former Chief Counsel of the IRS and Chair of the ABA Section of Taxation, has conceded the need to enlist expert assistance to give advice on core portions of the partnership tax law.<sup>64</sup> In addition, the General Accounting Office has reported on the ineffectual nature of the IRS's strategy for insuring compliance among partnerships and their partners.<sup>65</sup>

Furthermore, as noted above, the partnership tax rules were made even more difficult by the recent adoption of a general "anti-abuse" regulation in subchapter K. Although there continues to be some disagreement as to the meaning and scope of the regulation, as well as its wisdom and validity,<sup>66</sup> the adoption of the regulation is certainly not a positive

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maintain book capital accounts in the required manner or failure to include certain boilerplate provisions in the partnership agreement), failure actually to follow through on provisions in the partnership agreement mandated by the tax authorities (for example, refusal by the partners to make liquidating distributions in accordance with their capital account balances despite statements in the agreement that they will do so), and failure to satisfy legal standards (for example, failure to meet the substantiality test). One suspects that many smaller partnerships that are not particularly well-advised never even encounter the second and third set of issues because of their failure to satisfy one or more of the first type of requirements. Larger and better-advised partnerships may, in fact, clear the first hurdle by meeting the technical requirements of the first category of issues, but there is still doubt whether their actual behavior conforms to the specific provisions of their agreements. Recall that in the classic case of *Orrisch v. Commissioner*, 55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R.2d 73-1069 (9th Cir. 1973), where the special allocation of the taxpayers was invalidated, the problem was not the taxpayers' failure to maintain capital accounts correctly but, instead, doubt on the part of the court that the taxpayers would actually respect the account balances when a liquidation took place. At a 1996 ABA Tax Section meeting of the partnership committee, there was a similar discussion regarding whether clients really permit liquidating distributions to be made in accordance with their capital account balances when their agreement specifies that outcome. Finally, because of the amorphous nature of the substantiality test, there is serious question whether those partnerships satisfying the first two hurdles in fact comply with the third.

64. See N. Jerold Cohen, *It Always Looks Better When You Look Back*, 46 Tax Law. 683, 684 (1993).

65. See U.S. General Accounting Office, *IRS' Partnership Compliance Activities Could Be Improved*, GAO/GGD-95-151 (1995), reprinted in 95 TNT 118-21 (June 19, 1995) (LEXIS, FEDTAX library, TNT file). The IRS is attempting to increase its audit coverage of partnership returns. See Internal Revenue Service, *Examination Program Letter—FY 1997* (Nov. 1996), p. 7, reprinted in 97 TNT 32-45 (Feb. 18, 1997) (LEXIS, FEDTAX library, TNT file); Phil Brand, *IRS Releases 1997 Examination Program Letter*, 28 Tax Adviser 242 (1997).

66. Some commentary on the final version of the anti-abuse regulation includes Sheldon I. Banoff, *Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 66 Tax Notes 1859 (Mar. 20, 1995); Banoff, *supra* note 63; Frank V. Battle, Jr., *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax System*, 48 Tax Law. 801 (1995); Michael J. Grace, *Final Anti-Abuse Regulation Expanded and Clarified, but Uncertainties Remain*, 12 J. Partnership Tax'n 91 (1995); Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 Tax Law. 807 (1995); Richard M. Lipton, *The Partnership Anti-Abuse Regs. Revisited: Is There Calm After the Storm?*, 83 J. Tax'n 68 (1995); and Olson, *supra* note 63.

indication of the general health of the subchapter K rules. Indeed, some of the commentary published in response to the proposed version of the regulation illustrates examples of transactions meeting the literal terms of the statute and/or regulations yet reaching seemingly nonsensical results.<sup>67</sup>

Finally, it is evident that if one were writing on a clean slate, one would not adopt a set of operating rules like subchapter K that first touts their flexibility,<sup>68</sup> then proceeds to restrict that flexibility with a series of highly complex mechanical and sometimes subjective tests,<sup>69</sup> and then overlays on top of those tests a relatively amorphous supertest authorizing the disregard of the consequences of earlier tests despite plain compliance with them. Indeed, the general anti-abuse rule may apparently apply to negate a taxpayer's successful navigation of other anti-abuse rules adopted to monitor particular types of partnership-related transactions.<sup>70</sup> Something very fundamental must be awry in the basic structure of the rules for the law to have evolved into this unhappy state.

In short, the arguments against adopting a conduit tax system like subchapter K for the taxation of private business firms are extremely powerful ones. Yet it is not enough simply to decry the inadequacy of one particular approach; one must try to devise a workable alternative. Although a complete development and analysis of an entity tax approach which attempts to impose only a single level of tax on business income is beyond the scope of this article, some earlier analyses suggest the difficulty of that endeavor.<sup>71</sup>

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67. See, e.g., New York State Bar Association Tax Section, Report on the Proposed Partnership Antiabuse Rule, 64 Tax Notes 233 (July 11, 1994) [hereinafter N.Y.S.B.A. Tax Section Report]. The recent case of *ACM Partnership v. Commissioner*, 73 T.C.M. 2189 (1997) illustrates another large transaction which seemed to satisfy the literal provisions of the statute and regulations but reached an impermissible result. Cf. Regs. § 1.701-2(d), ex. 7. For recent commentary on the *ACM* case, see Steven M. Surdell, *ACM Partnership—A New Test for Corporate Tax Shelters?*, 75 Tax Notes 1377 (1997). For additional discussion of some of the current problems of subchapter K, see Staff of Joint Comm. on Tax'n, *Review of Selected Entity Classification and Partnership Tax Issues* 26 (Comm. Print 1997) [hereinafter 1997 JCT Partnership Tax Study]; William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 Tax L. Rev. 3 (1991); and William B. Brannan, *The Subchapter K Reform Act of 1997*, 75 Tax Notes 121 (1997).

68. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 65 (1954).

69. See, e.g., Regs. § 1.704-1, -2, and -3.

70. See Regs. § 1.701-2(d), ex. (8)(iii) (general anti-abuse rule may recast transaction already subject to (and presumably satisfying the requirements of) anti-abuse disguised sale rule in § 707).

71. See Michael L. Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 Tax L. Rev. 509 (1992) (describing implementation problems with Treasury's dividend exclusion model of integration, a slimmed-down (and much simplified) version of CBIT, and ALI Reporter's integration proposal); Yin, *supra* note 31, at 436-68.

In addition, an entity tax system starts with the fundamental flaw of taxing business income and losses at the wrong rate and not permitting the netting of related tax items. Finally, it also presents greater transitional concerns than adoption of a conduit system.<sup>72</sup>

To illustrate just one of the problems in implementing an entity tax approach, consider a scheme in which business income is taxed once at the entity level with distributions of already-taxed income then being tax-free to the owners of the firm. Such an approach, termed the "dividend exclusion prototype," was recommended by the Treasury Department in 1992 because, among other reasons, it represents "the most straightforward and easily administered" method of integration considered by the Department.<sup>73</sup> Consider just the single issue of how capital gain or loss arising upon a transfer of the ownership interests of a firm should be taxed under such a system.<sup>74</sup>

In theory, any capital gain or loss might reflect some combination of (1) income accumulated by the firm which has already been subject to the entity-level tax, (2) accumulated preference income which has escaped the entity-level tax, and (3) unrealized gains and losses of the firm (including the value of the firm's projected profits and losses). Neither the fully-taxed income nor the preference income should be taxed again upon the transfer of ownership interests, assuming there is a policy decision to pass through preferences. Presumably, however, there should be a tax on the capital gain or loss representing the unrealized entity-level gain or loss. How should the rules be designed to tax this last element while not taxing the portion of the capital gain or loss representing accumulated, previously taxed income or preference income?

One rough method of accomplishing that end, suggested by both the Treasury Department and the ALI Reporter in their integration proposals, is to provide outside basis adjustments equal to the fully-taxed and preference income (assuming passthrough of preference income) not distributed by the

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72. Requiring all private business firms to be taxed in the same way, either under a conduit or an entity tax approach, would present transitional problems because of the change from current law. A conduit approach, however, is already in effect for those firms currently subject to subchapters K or S. In contrast, an entity tax approach imposing only a single level of taxation on business income would represent a new system for all firms.

73. U.S. Dep't of Treasury, *A Recommendation for Integration of the Individual and Corporate Tax Systems*, Dec. 1992, letter from Nicholas Brady, Secretary of the Treasury, to Dan Rostenkowski, Chairman, U.S. House Comm. on Ways and Means, p.1.

74. Any gain or loss on the sale of ownership interests need not, of course, constitute capital gain or loss. The reference in the text to capital gain or loss is simply shorthand for the gain or loss arising from the sale of ownership interests, no matter what the actual character of that gain or loss is.

firm.<sup>75</sup> Analytically, the procedure, termed a “dividend reinvestment plan” or “DRIP” by the Treasury, would allow firms to retain their earnings but to declare constructive distributions followed by constructive reinvestments of those amounts back to the firm. The distributions would be tax-free to the distributees, and the reinvestments would produce the desired increase in outside basis. At least in theory, if all retained earnings were made subject to a DRIP, then capital gain and loss would reflect only unrealized gains and losses at the firm level. If such gain and loss were taxed, an inside basis adjustment could be made to preclude the same gain or loss from being taxed again when realized by the firm.

A DRIP, however, is nothing more than an allocation of undistributed income among the owners of the firm, the core requirement of existing subchapter K. Although the ramifications of a DRIP under an entity-level tax would be less significant than under subchapter K because the income being allocated under the DRIP would already have been subject to tax, nevertheless the practical difficulties with the allocation would be the same. If a set of rules could be developed to specify the appropriate outside basis adjustments for private business firms with tiers of owners and preferential, contingent, and inchoate ownership interests, among other things, those same rules could be utilized to implement a conduit tax system. In addition, the necessary, accompanying inside basis adjustment might encounter the same problems as under the current law of subchapter K.<sup>76</sup>

Both the Treasury and the ALI Reporter suggested an elective DRIP to be fashioned by the taxpayer. But an elective DRIP would still face the same problems, the only difference being that there would be an initial, ad hoc development of taxpayer-favorable allocation schemes. Also, in certain circumstances, firms might find it advantageous from a tax standpoint not to distribute constructively all of their retained earnings. No doubt, there would follow the inevitable Congressional and Treasury responses to those schemes—like a “substantial economic effect” test in order to validate a DRIP—with resulting considerable complication. In short, adoption of a DRIP may encounter many of the same daunting allocation problems now dealt with under subchapter K.

Another possible solution is to tax the capital gains, forgo a DRIP and any basis adjustments, and simply permit the liberal utilization of capital losses. The theory is that to the extent the capital gain ought not be taxed because it represents fully-taxed or preference income accumulated by the

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75. See Treasury Integration Report, *supra* note 28, at 87-88; American Law Institute, Federal Income Tax Project—Integration of the Individual and Corporate Income Taxes—Reporter’s Study of Corporate Tax Integration 126-27 (1993) (proposal 5) [hereinafter ALI Reporter’s Integration Study].

76. See IRC §§ 734, 743, and 755.

firm, there will subsequently be an offsetting capital loss to the purchaser of the ownership interest when the income is distributed out of the firm. Thus, so long as the capital loss can be easily utilized, overall double taxation would be avoided. One problem with this approach, however, is that the offsetting capital loss may not arise until many years after the capital gain is incurred and the tax is paid. Further, there is a potential rate arbitrage problem: the seller who incurs the capital gain may not be taxed at the same rate as the purchaser who obtains the capital loss. Finally, full taxation of capital gains without a DRIP, even with liberal availability of capital losses, might place undue pressure on firms to distribute their earnings.

The opposite approach, also suggested by the Treasury Department, would be to exempt the capital gain from taxation.<sup>77</sup> As noted, the only element of the capital gain that ought to be taxed is the amount equal to the unrealized gains or losses at the firm level. But such gains or losses can be taxed when realized by the firm. Thus, a capital gains exemption (and, of course, nonrecognition of capital losses) would still permit a single tax to be collected ultimately on all income earned by the firm. Moreover, it would do so in a very simple fashion, without the need of a DRIP or inside basis adjustments.

The principal problem with this idea is the deferral that would be permitted, and the resulting distortions potentially created. If an acquisition of the ownership interests of a firm were tax-free but the acquisition of the firm's assets were not, there would be a clear bias in favor of the former transaction. This bias might be similar to or even greater than the bias under current law of an acquisition of corporate stock (which ordinarily results in only one tax) over an acquisition of the corporation's assets (which may result in two taxes). To be sure, the magnitude of the bias is uncertain. It might be offset to some extent by an implicit tax imposed in the capital gains transaction if the price for the ownership interests takes into account the unrealized gains and future tax liability at the entity level. Nevertheless, because taxation of those gains would continue to be deferred, the implicit tax would likely be much smaller than the explicit tax arising on an asset sale, so that some distortion would be caused.

Accelerating entity-level realization events would reduce the distortion because it would cause the implicit tax to be closer in amount to the explicit tax. For example, exemption of capital gains might be accompanied by a mandatory section 338-type rule triggering an entity-level realization event upon a sufficient change in ownership of a firm. But implementing a mandatory section 338 regime would be extraordinarily

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77. See Treasury Integration Report, *supra* note 28, at 83.

difficult.<sup>78</sup> It would in most cases force an undesirable result on the taxpayer, in contrast to existing section 338 which was originally designed to provide a taxpayer-favorable election. Thus, the major thrust of the qualification rules in a mandatory section 338 environment would be to devise a net from which the taxpayer could not escape, much like the rules for section 382, surely no model for simplicity.<sup>79</sup>

In summary, achieving the proper tax treatment of capital gains in an entity tax system would present a formidable challenge and is illustrative of the difficulties to be encountered in devising such a system. There are the same age-old trade-offs between equity and simplicity, with the price of "getting it right" in an entity tax system being perhaps as high as doing so in a conduit system.

#### D. Summary and Conclusion

As difficult as it is to implement a conduit tax system, there does not seem to be any clear advantage to developing an entity tax approach for the taxation of private business firms. Each system, as implemented, includes certain basic flaws in the taxation of business income. In addition, each system may encounter similar problems in facilitating taxpayer compliance and IRS review. An entity tax approach has the additional disadvantage of presenting greater transitional concerns.

But this rather pessimistic resolution of this issue would seem to create a dilemma for policymakers. If subchapter K, the most refined conduit system in existence, is already viewed as placing intolerable burdens on taxpayers and the IRS alike, and further, necessary reforms would likely make it even more difficult to comply with and administer, then how can that subchapter be mandated as the uniform method of taxation for all private business firms? Wouldn't such a recommendation simply lead to disregard of the law even more widespread than at the present time?

This article suggests a way out of that dilemma. Specifically, two versions of conduit taxation should be pursued. One version should reform subchapter K to prevent potential abuses of those rules even at the cost, if necessary, of some additional complication. Subchapter K, as reformed, will sometimes be referred to as the "default version of conduit taxation" in this article. The other version should focus on providing an administrable set of conduit rules with some concession, if necessary, to not achieving the correct

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78. See George K. Yin, A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution, 37 Tax Notes 415, 418-20 (Oct. 12, 1987).

79. Still another possible approach would be to tax the capital gains but to permit such gains to be excluded from income if the taxpayer agrees to accelerate the entity-level gains. Cf. IRC § 338(h)(10).

outcome in all cases. The next part of the article describes the theory behind, and the specific provisions of, the simplified version of conduit taxation.<sup>80</sup>

#### IV. A SIMPLIFIED VERSION OF CONDUIT TAXATION

##### A. Introduction

Development of the simplified version of conduit taxation described in this article used subchapter K as its starting point. This point of departure might seem odd given the complex nature of that subchapter. On the other hand, subchapter K represents the purest version of conduit taxation in existence. As explained in greater detail in the next section, the theory was to begin with subchapter K and to try to strip off as many of the complicating features of the law as possible in order to develop a simple core of conduit principles and rules. The key was in fashioning eligibility rules which would enable one to discard the "extraneous" portions of subchapter K.

Subchapter S was not selected as the initial model because of its entity tax features which seemed inconsistent with a conduit tax objective. Those features are a natural outgrowth of subchapter S's original application only to corporations and its close relationship with subchapter C. But they seemed to make subchapter S an unsound foundation on which to construct a simplified conduit version applicable to all forms of business organization.<sup>81</sup>

Despite this initial step, the proposal has evolved into one which has a strong resemblance to subchapter S. In part, this result can be explained by the historical roots of that subchapter. Subchapter S was enacted in 1958 to reduce the impact of tax consequences on the choice of business form and to remove the double tax burden on, and permit the passthrough of losses by,

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80. Consideration of possible subchapter K reforms for the default version of conduit taxation is beyond the scope of this article. One commentator has suggested a similar "two-track" approach except that he would develop an entity tax system to be mandatorily applicable to those firms not qualifying for his simple conduit approach. See Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 *Tax Law* 229 (1998).

81. Interestingly, one of the "entity" tax features of subchapter S—the requirement that a firm recognize gain upon a distribution of appreciated property—was included in subchapter S in 1982 *prior to its inclusion in subchapter C*. Later amendments in 1984 and 1986 extended and expanded the rule in subchapter C, thereby making the S rule superfluous. See Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, reprinted in 1982-2 C.B. 702, 706 (enacting former IRC § 1363(d)); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 54(a)(1), 98 Stat. 494, 568 (amending former IRC § 311(d)(1)); Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), (c), 100 Stat. 2085, 2269, 2272 (amending IRC §§ 311, 336).



small businesses.<sup>82</sup> Although the creation of an administrable set of provisions was not stated as a specific objective, it is evident that Congress included consideration of that goal in crafting the rules.<sup>83</sup> Whether Congress has achieved that goal is a matter of some disagreement,<sup>84</sup> but most observers surely would agree that subchapter S is simpler than subchapter K.<sup>85</sup> Thus, in trying to develop a simplified conduit approach to a particular tax issue, it was natural to consider the rule in subchapter S. Indeed, for reasons explained below, the basic structure of subchapter S serves as a remarkably coherent version of a simplified conduit system.

Subchapter S provided another important advantage. One worry in trying to fashion a simpler set of rules is the possibility that they will not adequately protect the fisc. Elimination of complicated subchapter K provisions intended to prevent inappropriate tax outcomes might result in such outcomes being resurrected within the simplified conduit system. Subchapter S, however, offers an instructive 40-year track record of taxpayers and transactions subject to those rules. Thus, if an inappropriate transaction has not arisen under that subchapter, it may be indicative of the experience one could expect under a new system modeled after one or more of its rules.

A difficulty with relying too heavily on subchapter S, however, is its somewhat perverse relationship to subchapter K. Assuming that use of the simplified conduit version is a matter of explicit or transactional election by the taxpayer, then the substantive tax outcomes under that version must be compared to those under the default conduit version, i.e. some variation of subchapter K. Unless the results under the simplified version are roughly equivalent to (or indeed, more taxpayer-favorable than) the results under the

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82. See S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted in 1958-3 C.B. 922, 1008.

83. For example, in explaining the reason for the one class of stock rule contained in an early proposal of what eventually became subchapter S, the Senate report describes the "great complications" that would arise under a contrary rule. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 453-54 (1954) (Serial Set 11735).

84. See Burgess J.W. Raby & William L. Raby, *S Corporation AAA and OAA—Alphabet Soup or Taxpayer Stew?*, 78 *Tax Notes* 1013, 1013 (1998) (describing subchapter S as "remarkably complicated"); Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 *Tax Notes* 1679, 1684 (1996) (subchapter S is "extraordinarily complex").

85. See Berger, *supra* note 63, at 110 (greater reliance upon the "relatively simple foundation of subchapter S, rather than upon the intricately ornate base of subchapter K [would permit] most of the arcane complexity from this sector of tax law [to disappear]"); Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 *Tax L. Rev.* 665, 669 (1992) ("one thing that makes subchapter S look really good is subchapter K, the awesomely complex partnership tax provisions"); Deborah H. Schenk, *Commentary: Complete Integration in a Partial Integration World*, 47 *Tax L. Rev.* 697, 712 (1992) ("one of the hallmarks of subchapter S is its . . . simplicity [relative to subchapter K].").

default system, use of the simplified version might well be discouraged. Yet current subchapters K and S do not have that relationship. Subchapter S is simpler than subchapter K but it also generally produces tax results less favorable to taxpayers. As a result, some commentators have predicted the demise of subchapter S and some have even urged its repeal.<sup>86</sup>

For reasons described in part III, this article contends that it is important to preserve a simplified version of conduit taxation for as many private business firms as possible. To accomplish that end, it is necessary to reconfigure somewhat the tax consequences under subchapters S and K. Far from being repealed, the former should generally be liberalized; in contrast, some of the vaunted flexibility of the latter should be curtailed. The challenge is achieving the right balance: liberalization of subchapter S should not result in any significant loss of simplicity, and modifying subchapter K should not cause it to produce significantly incorrect results.

The next section describes the theoretical underpinning of the simplified version of conduit taxation. It explains why the availability of "simple" rules is necessarily tied to the characteristics of the firms and owners subject to those rules. Accordingly, the proposal limits applicability of the simplified version to a subset of private business firms referred to in this article as "simple private business firms" (SPBFs). Section C then outlines the basic operating provisions of the simplified system, which generally consists of a liberalized version of subchapter S.

### *B. Eligibility for the Simplified Version: Theory and Definition*

Over 40 years ago, the reporters and two consultants to the ALI project on partnership tax described the source of the difficulty in subchapter K in the following way:

Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this allocation, the issues are

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86. See Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 *Tax L. Rev.* 815, 831 (1992) (predicting demise); Schler, *supra* note 84, at 1684-85 (urging repeal); Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 *Va. Tax Rev.* 591, 593 (1996) (same); Willard B. Taylor, *Beyond Check-the-Box—Neglected Issues*, 75 *Taxes* 671, 674 (1997) (same); compare Ginsburg, *supra* note 85, at 665 n.3 ("[w]hile in the past some have suggested replacing subchapter S with an extension of subchapter K to electing corporations, a proposition that commends itself mainly to those who find the level of complexity in federal tax law much too low . . .").

essentially not between Treasury and taxpayer-partner but between partner and partner.<sup>87</sup>

The passage of time since publication of that statement has revealed that the authors were only partly correct. Certainly, one of the principal difficulties of partnership tax has been the distribution or allocation of the tax burden of the business firm among the owners of the business. But in contrast to the second sentence of the quoted statement, which lay the groundwork for the authors' proposal of what is now section 704(a), it would appear that the Treasury Department *is* greatly concerned with the manner of allocation. For example, the regulations under section 704 evidence Treasury's concern that the flexibility of the subchapter K rules will be used to shift tax items from one owner to another. This concern is not limited to the possibility that income will be shifted from high-taxed to low-taxed persons, while deductions flow from the low-taxed to the high-taxed. Also included are possible shifts of particular categories of income—section 1231 gains and losses, foreign-source income and deductions, capital gains and losses, and so forth. Moreover, the shift need not necessarily be within a particular time period. The shifting of income, losses, and other tax items recognized in different time periods may also be objectionable.<sup>88</sup>

This section attempts to identify the characteristics of firms for which the second sentence of the ALI reporters' statement would also be true, that is, firms whose tax issues would be essentially between owner and owner rather than between the Treasury and the taxpayer. If the characteristics of such firms (termed "SPBFs") offer only limited potential for the type of tax advantages that the Treasury is worried about, then the firm can be provided with an operating rule structure consisting of a stripped-down version of subchapter K, one that eliminates many of the administrative and compliance requirements of those provisions. To be sure, the eligibility conditions of an SPBF cannot be so precise as to preclude every possible instance of the firm being used to achieve an advantageous tax result. Nevertheless, the objective of the SPBF proposals is to balance a concern of protecting the fisc with a desire to provide an administrable set of tax operating rules for as many firms as possible.

The SPBF definition contains two basic eligibility conditions similar to those used in defining an S corporation. First, the owners of an SPBF must generally all be individuals. In addition, an SPBF may have only one class

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87. J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & William C. Warren, A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft, 9 Tax L. Rev. 109, 112 (1954).

88. Cf. *ACM Partnership v. Commissioner*, 73 T.C.M. 2189 (1997); Regs. §§ 1.701-2(d), ex. (7), 1.704-1(b)(2)(iii)(c) (transitory allocations invalid).

of residual ownership interests. The terms and rationale for these conditions are discussed in further detail below. A final section explains why other conditions are not proposed.

1. *Ownership Limitations.*—As noted, one of the principal reasons for the tremendous complexity in subchapter K is the desire to prevent the shifting of tax items from one owner to another. Shifting strategies, however, are only advantageous if the parties participating in the shift are in different tax situations. Thus, if all owners of a private business firm have and continue to have exactly the same tax profile, many of the protective rules of subchapter K could be eliminated. As a practical matter, of course there are far too many potential tax differences among taxpayers to ever insure, other than on a case-by-case basis, absolutely *identical* tax profiles among the owners of a private business firm. But if, for example, all owners of a subset of firms were in at least the 28% marginal income tax bracket, it might be unlikely that such firms would be utilized on a widespread basis to gain the potential tax advantages from certain shifting strategies.<sup>89</sup> An important goal of the ownership limitations described in the next sections is to try to insure that owners of an SPBF will have more-or-less the same general tax profile.

a. *Individuals as Owners.*—The following Table 1 breaks down by AGI class the number of individual income tax returns on which either partnership or subchapter S income or loss was reported in 1994, the latest year for which such data is available. An examination of the tax profile of individuals who have invested in partnerships and S corporations in the recent past offers some insight into the likely profile of the individuals who will be future SPBF owners.

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89. One might expect that the transaction costs of shifting would make it uneconomic if the shifting of income and losses or deductions occurred between taxpayers in the 28% bracket and those in the 36% or 39.6% bracket. This broad generalization ignores the potential advantage of shifting particular tax items, such as § 1231 gains and losses, capital gains and losses, and passive income and losses, the advantage from which is not necessarily a function of the marginal income tax bracket of the taxpayer. That concern is addressed later in connection with the rule limiting an SPBF to one with a single class of residual ownership interests.

Table 1  
 Number of Individual Income Tax Returns  
 Reporting Partnership or S Corporation Income or Loss,  
 by AGI Class (1994)  
 (numbers in 000s)

(1) AGI Class (\$000)	(2) # rets. filed	(3) % of total rets.	(4) Cum % of col. (3)	(5) # w/ K&S inc.	(6) % tot. w/K&S inc.	(7) Cum % of col. (6)	(8) # w/ K&S loss	(9) % tot. w/K&S loss	(10) Cum % of col. (9)	(11) # w/ K&S loss	(12) % tot. w/K&S loss	(13) Cum % of col. (12)
0	953	0.8%	0.8%	44	1.3%	1.3%	153	7.3%	7.3%	197	3.5%	3.5%
1-5 <sup>90</sup>	14,632	12.6%	13.4%	88	2.5%	3.8%	59	2.8%	10.1%	147	2.6%	6.1%
5-10	14,235	12.3%	25.7%	122	3.5%	7.3%	77	3.7%	13.8%	199	3.6%	9.7%
10-15	13,465	11.6%	37.3%	161	4.6%	11.9%	106	5.0%	18.8%	267	4.8%	14.5%
15-20	11,411	9.8%	47.1%	185	5.3%	17.2%	89	4.2%	23.0%	274	4.9%	19.4%
20-25	9,663	8.3%	55.4%	162	4.6%	21.8%	85	4.0%	27.0%	247	4.4%	23.8%
25-30	8,121	7.0%	62.4%	147	4.2%	26.0%	105	5.0%	32.0%	252	4.5%	28.3%
30-40	12,014	10.4%	72.8%	315	9.0%	35.0%	196	9.3%	41.3%	511	9.1%	37.4%
40-50	9,024	7.8%	80.6%	267	7.6%	42.6%	198	9.4%	50.7%	465	8.3%	45.7%
50-75	13,127	11.3%	91.9%	542	15.5%	58.1%	385	18.3%	69.0%	927	16.6%	62.3%
75-100	4,784	4.1%	96.0%	365	10.5%	68.6%	202	9.6%	78.6%	567	10.1%	72.4%
100-200	3,405	2.9%	98.9%	627	18.0%	86.6%	265	12.6%	91.2%	892	16.0%	88.4%
200-500	890	0.8%	99.7%	342	9.8%	96.4%	138	6.6%	97.8%	480	8.6%	97.0%
500-1000	149	0.1%	99.8%	81	2.3%	98.7%	28	1.3%	99.1%	109	1.9%	98.9%
1000+	70	0.1%	99.9%	44	1.3%	100.0%	14	0.7%	99.8%	58	1.0%	99.9%
Total	115,943			3,492			2,100			5,592		

Source: IRS Statistics of Income, Individual Income Tax Returns 1994, Publ. 1304 (1997), Table 1.4, cols. (1), (73), and (75). Numbers do not add to 100% due to rounding.

The IRS statistics underlying the data set forth in Table 1 unfortunately do not provide any indication of the filing status of the taxpayer filing the return (single, joint, married filing separately, or head of household). It may, however, be reasonable to assume that on average, 1994 returns reporting adjusted gross income below about \$40,000 represented taxpayers in the 15% or lower marginal income tax bracket.<sup>91</sup> Based on that assumption,

90. This category represents all returns with AGI greater than zero but less than \$5,000.

91. In 1994, married taxpayers with taxable income below \$38,000 were in the 15% bracket; for heads of household, the figure was \$30,500; for single individuals, \$22,750; for married filing separate, \$19,000. IRC § 1(a)-(d), (f). To estimate the average AGI cut-off point for the 15% tax bracket, we first increased the taxable income amount for each category of tax return filer by a personal exemption amount (\$2,450 in 1994; two exemptions were assumed for joint filers and heads of household) and the 1994 standard deduction (\$6,350 for joint filers, \$5,600 for heads of household, \$3,800 for singles, and \$3,175 for married filing

Table 1 indicates that roughly 37.4% of the returns reporting partnership or S corporation income or loss in 1994 were filed by taxpayers in the 15% or lower tax bracket, and roughly 62.6% were filed by taxpayers in the 28% or higher bracket.<sup>92</sup> In contrast, approximately 72.8% of all returns were filed by taxpayers in the 15% or lower tax bracket, and approximately 27.2% were filed by taxpayers in the 28% or higher bracket.<sup>93</sup> Other data reveals that about 13% of the returns reporting partnership or S corporation income or loss were "nontaxable returns" reporting no income tax liability, and therefore, the taxpayers filing them might be considered to have been in the 0% tax bracket.<sup>94</sup> Putting all of this information together, a rough profile of the individual taxpayers reporting partnership or S corporation income or loss in 1994 is as follows:

<u>marginal income tax bracket of tax return filer</u>	<u>% of all returns filed by individuals reporting K or S income or loss</u>	<u>% of all returns filed by individuals</u>
0 percent	13%	not avail.
15 percent	24.4%	not avail.
0 or 15 percent	37.4%	72.8%
28 percent or higher	62.6%	27.2%

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separately). IRC §§ 63(c), 151(d). We then averaged the estimated AGI cut-off points in each category for the 15% tax bracket (\$49,250 for joint filers, \$41,000 for heads of household, \$29,000 for singles, and \$24,625 for married filing separately) based on the percentage of filers in each category in 1994 (joint - 41.7%, head of household - 13.0%, single - 43.0%, and married filing separately - 2.1%). See IRS Statistics of Income, Individual Income Tax Returns 1994, Publ. 1304 (1997) [hereinafter 1994 SOI Individual], Table 1.3, cols. (1), (3), (5), (7), and (11), at 36-37. The result was an estimated, overall AGI cut-off in 1994 for the 15% tax bracket of \$38,854 ( $\$49,250 \times 41.7\% + \$41,000 \times 13.0\% + \$29,000 \times 43.0\% + \$24,625 \times 2.1\%$ ). Because the minimum number of exemptions and the standard deduction were both assumed, the actual figure would be higher than \$38,854, hence the assumption of about \$40,000 in the text.

Another recent study has estimated that in 1994, there were approximately 25,562,000 returns filed by taxpayers in the 28% or higher tax bracket. See Therese M. Cruciano, Individual Income Tax Rates and Tax Shares, 1994, 16 SOI Bulletin 7, 10 (Spring 1997) (figure C). Counting up from the bottom of column (2) of Table 1 indicates that the break between the 15% and 28% tax brackets occurs somewhere between \$40,000 and \$50,000 of AGI.

92. Table 1, col. (13), line 8.

93. Table 1, col. (4), line 8.

94. 1994 SOI Individual, supra note 91, Table 1.4, cols. (73) and (75), at 44, and pp. 126-27.

Thus, as one might expect, individual participants in partnerships or subchapter S corporations in 1994 were, on average, in higher income tax brackets than tax return filers generally, with almost two-thirds of those reporting K or S items belonging in the 28% tax bracket or higher. Nevertheless, there were a surprisingly high number of low-bracket K or S individual participants as well. This conclusion might suggest that there would be ample opportunity for income shifting between low- and high-bracket owners of a private business firm. For a number of reasons, however, the figures probably exaggerate the extent of that potential problem if the firm is limited to individual owners.

For one thing, low-bracket taxpayers may pair up with one another to participate in a common private business firm. Although pairing of that sort would increase their overall participation rate in such ventures, it would not create a significant concern of tax item shifting.

Second, the figures in Table 1 indicate the likely tax bracket of partners and S corporation shareholders *after* their share of pass-through income or loss is taken into account. But to evaluate the potential availability of a shifting strategy from investment in a pass-through entity, the tax bracket of the participants should be known *before* taking into account their share of pass-through items. For example, two high-income partners might shelter most or all of their income through losses generated by their two-person partnership, thereby making them both appear to be low-bracket taxpayers after such losses are taken into account. Yet that sheltering would not result from an inappropriate shifting of tax items between high and low-bracket taxpayers, nor would that outcome be possible under those facts. There is some evidence in the data to support this explanation as one reason for the surprisingly high level of participation shown by Table 1 of low-bracket taxpayers in partnerships and S corporations.<sup>95</sup>

Third, a small number of low-bracket taxpayers reporting partnership or S corporation income or loss in 1994 apparently were subject to the

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95. Of those taxpayers reporting K or S net *income*, only 1.3% were in the \$0 AGI class. In contrast, of those taxpayers reporting K or S net *loss*, 7.3% were in the \$0 AGI class. See Table 1, cols. (6) and (9), line 1. In addition, the amount of K or S net losses claimed by taxpayers with \$0 AGI represented almost 40% of all such losses claimed, whereas the amount of K or S net income reported by taxpayers with \$0 AGI represented less than 1% of all such income reported. 1994 SOI Individual, *supra* note 91, Table 1.4, cols. (74) and (76), at 44. These figures suggest that K and S losses helped to make some numbers of partners and S shareholders appear to be low-bracket taxpayers even though before such losses are taken into account, they may have been high-bracket taxpayers.

alternative minimum tax.<sup>96</sup> Thus, their marginal income tax bracket was either 26% or 28%, the minimum tax rates, rather than 15% or lower.<sup>97</sup>

Fourth, the figures in Table 1 only reflect participation in partnership and S corporation ventures by number of returns filed. If participation is measured by amount of net income reported, a different picture is revealed:

Table 2  
Amount of Partnership or Subchapter S Net Income  
Reported on Individual Income Tax Returns,  
by AGI Class (1994)

(1) AGI Class (\$000)	(2) K or S Net Inc. Reported (\$ million)	(3) % of Tot. K or S Net Inc. Reported	(4) Cum % of Col. (3)
0	\$ 1,136	0.7%	0.7%
1-5 <sup>98</sup>	205	0.1%	0.8%
5-10	507	0.3%	1.1%
10-15	995	0.6%	1.7%
15-20	1,096	0.7%	2.4%
20-25	1,078	0.7%	3.1%
25-30	1,233	0.8%	3.9%
30-40	3,297	2.1%	6.0%
40-50	2,718	1.8%	7.8%
50-75	7,300	4.7%	12.5%
75-100	7,270	4.7%	17.2%
100-200	24,054	15.6%	32.8%
200-500	34,536	22.4%	55.2%
500-1,000	19,658	12.7%	67.9%
1,000 +	49,193	31.9%	99.8%
Total	\$154,277		

Source: IRS Statistics of Income, Individual Income Tax Returns 1994, Publ. 1304 (1997), Table 1.4, col. (74). Col. (4) does not add to 100% due to rounding.

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96. About 93,000 tax returns, or roughly 1.7% of all returns reporting partnership or S corporation income or loss, had AGI of under \$10,000 yet were "taxable returns" and therefore reported income tax liability. See 1994 SOI Individual, *supra* note 91, Table 1.4, cols. (73) and (75), at 44, and pp. 126-27. Because a taxpayer with AGI of less than \$10,000 probably had no regular income tax liability, these returns were likely reporting minimum tax.

97. IRC § 55(b)(1)(A).

98. See *supra* note 90.



Table 2 indicates that in 1994, only 6% of total partnership or subchapter S net income reported on individual income tax returns was reported on returns having AGI of less than \$40,000, which we have assumed to represent a rough proxy for taxpayers in the 15% or lower tax bracket.<sup>99</sup> This figure indicates that if partnerships and S corporations were utilized previously to shift income from high- to low-bracket individual taxpayers, only a relatively small amount of income was involved. Of course, the proposals contained in this article might change that pattern in the future. Nevertheless, the figures suggest that at least historically, such entities have not been widely employed to shift income between high- and low-bracket individuals.<sup>100</sup>

Finally and perhaps most importantly, regardless of how many low-bracket taxpayers have participated in partnerships and S corporations in the past and might be expected to participate in an SPBF in the future, they are able to shelter only a limited amount of income before higher brackets would apply to them. The one exception would be a zero-bracket individual taxpayer with a large net operating loss carryover, but that apparently is a fairly uncommon situation.<sup>101</sup> Thus, the transaction costs to design a tax shelter involving low- and high-bracket individual taxpayers may be fairly high. Many low-bracket taxpayers would have to be assembled before any significant amount of income of the high-bracket taxpayers could be sheltered. The transaction costs might be particularly high if one further assumes that low-bracket taxpayers who truly have low incomes may be

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99. Table 2, col. (4), line 8.

100. The same inference can be drawn from data appearing on Table 1. For each AGI category greater than \$0 and less than \$40,000, roughly the same percentage of taxpayers reported partnership or S corporation loss as reported partnership or S corporation income. See Table 1, cols. (6) and (9), lines (2)-(8). If shifting strategies involving low-bracket individuals had been widely utilized, one would expect to see greater percentages of the low AGI categories reporting pass-through income rather than pass-through losses.

101. For 1994, only 431,277 individual income tax returns out of a total of almost 116 million filed, or about 0.4% of all individual returns, claimed a net operating loss deduction for a loss arising in a prior taxable year. See 1994 SOI Individual, supra note 91, Table 1.4, col. (97), at 46. (The term "net operating loss" used in the IRS tables refers to net operating loss deductions claimed in 1994 for prior year losses, and not to net operating losses arising in 1994 which may be carried back or forward to other years. See *id.* at 118-19.)

Although the claiming of an NOL deduction by an individual is therefore infrequent, the amount of deduction claimed may be sizable. In 1994, a total of \$47.045 billion in NOL deductions for losses from prior years were claimed by individuals, or an average NOL deduction of \$109,000 per claim. See *id.*, Table 1.4, col. (98), at 46. One might speculate that NOL deductions of individuals are naturally and quickly used up as the level of the individual's income and loss fluctuates from year to year because individuals could not be expected to suffer losses for an extended period of time. If this is true, then there may not be a large pool of NOLs belonging to individuals which would be available to offset income from a tax shelter investment. But we have as yet uncovered no data to support or refute this speculation.

fairly hard to identify due to their relative lack of sophistication in financial matters.<sup>102</sup>

All of the foregoing reasons support the conclusion that an SPBF with only individuals as owners does not present significant opportunities for income and loss shifting.<sup>103</sup> Accordingly, a more relaxed set of tax operating rules for an SPBF is permissible in that situation.

b. *Public Subchapter C Firms as Owners.*—The picture changes rather dramatically if public firms taxable under subchapter C are also permitted to be owners of an SPBF. Many C corporations have net operating losses, which means that they not only are in a zero marginal income tax bracket but also may be able to shelter a significant amount of income in a given year.

For example, in 1993, the latest year for which such data is available, just slightly over one-half of the corporate income tax returns filed (other than returns of S corporations, RICs and REITs) reported net income.<sup>104</sup> The C corporation returns without net income reported an aggregate loss of over \$127 billion, an average loss of over \$136,000 for each C corporation return without net income.<sup>105</sup> Moreover, over 39% of the C corporation returns with net income claimed a net operating loss deduction from a prior year loss, with a total of over \$45 billion in such deductions claimed.<sup>106</sup>

The foregoing information relates to income tax returns filed by both public and closely-held C corporations. To estimate the likely NOL situations of *public* C corporations, Table 3 provides data regarding the amount of corporate NOL deductions claimed in 1993, broken down by the asset size of the corporation whose return made the claim.

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102. But see Boris I. Bittker, *Tax Shelters for the Poor?*, 51 *Taxes* 68 (1973) (tongue-in-cheek description of partnership venture operating coin-operated washing and vending machines in basement of low-income housing project, in which low-income tenant-partners with "excess" personal exemptions and standard deductions are allocated pre-depreciation income of venture and high-bracket investor-partners are allocated depreciation deductions).

103. Again, this conclusion does not apply to possible shifts involving particular tax items of the firm, such as capital gains and losses. That concern is addressed below.

104. Internal Revenue Service, 1993 *Statistics of Income, Corporation Income Tax Returns*, Publ. 16 (1996) [hereinafter 1993 SOI Corporate], Table 18, col. (1). We treat the category of corporate income tax returns other than S, RIC, or REIT returns as a proxy for C corporation returns.

105. 1993 SOI Corporate, Table 18, cols. (1) and (2).

106. *Id.* Corporate net operating loss carrybacks to 1993 are not included in the IRS statistics. See *id.* at 181. The fact that the C corporation losses reported in 1993 were almost three times the amount of the net operating loss carryforwards deducted in 1993 may suggest either a significant amount of NOL carrybacks not reflected in these statistics or large amounts of unused NOLs.

Table 3  
Corporate NOL Deductions Claimed,  
By Asset Size of Corporation Filing Return (1993)

(1) Asset Size	(2) # corp. rets. (000s)	(3) # rets. w/NOL ded. (000s)	(4) % rets. w/NOL ded. (3)÷(2)	(5) NOL. ded. (\$M)	(6) % of Tot. NOL ded.	(7) Avg. NOL ded. per claim (\$000s) (5)÷(3)
\$0	239.3	20.93	8.7%	\$ 1,773.4	3.9%	\$ 84.7
\$1-\$100K	2,049.6	224.74	11.0%	2,085.5	4.6%	9.3
\$100K-\$250K	635.3	80.47	12.7%	1,470.0	3.3%	18.3
\$250K-\$500K	394.2	48.55	12.3%	1,305.7	2.9%	26.9
\$500K-\$1M	269.3	28.91	10.7%	1,496.4	3.3%	51.8
\$1M-\$5M	279.1	27.54	9.9%	3,420.6	7.6%	124.2
\$5M-\$10M	40.1	3.97	9.9%	1,294.9	2.9%	326.2
\$10M-\$25M	25.9	3.14	12.1%	2,075.4	4.6%	661.0
\$25M-\$50M	11.4	1.50	13.2%	1,771.0	3.9%	1,180.7
\$50M-\$100M	8.0	1.06	13.3%	2,276.0	5.0%	2,147.2
\$100M-\$250M	6.6	.82	12.4%	2,629.4	5.8%	3,206.6
\$250M +	6.8	1.12	16.5%	23,560.7	52.2%	21,036.3
Total	3,964.6	442.74	11.2%	\$45,158.9		\$ 102.0

Source: Michael G. Seiders, Corporation Income Tax Returns, 1993, 16 SOI Bulletin 36, 51-54 (summer, 1996) (Table 2). Certain information was obtained from a telephone conversation between John Comisky, economist at the Statistics of Income, and the author. The data only reflects net operating losses carried forward to, and deducted in, 1993. Data concerning NOLs carried back to 1993 is not included.

According to Table 3, more than half of the corporate NOL deductions in 1993 were claimed on returns for corporations with assets in excess of \$250 million, the largest asset size category available from IRS statistics, and about 63% of those deductions were claimed on returns for corporations with assets greater than \$50 million.<sup>107</sup> Except for the initial category of returns showing \$0 assets, the average NOL deduction per claim steadily increases with the size of the corporate claimant, with corporate returns in the largest asset size category claiming an average NOL deduction of over \$21 million.<sup>108</sup> Moreover, these figures only reflect NOL deductions

107. Table 3, col. (6), lines 10-12.

108. Table 3, col. (7).

carried forward to 1993 from a prior taxable year.<sup>109</sup> Hence, the average NOL carryforward *and* carryback deduction in 1993 was larger than these numbers.

In 1993, there were 12,764 10-K forms filed with the SEC, an indication of the number of domestic public corporations in existence in that year.<sup>110</sup> Over 60% of those companies were listed on either the New York Stock Exchange, the American Exchange, or the Nasdaq.<sup>111</sup> Data for companies listed on the American Exchange in that year indicates a median asset size of \$58.3 million and a mean asset size of \$330.4 million.<sup>112</sup> Nasdaq companies seem to have a similar profile, and New York Stock Exchange companies appear to be larger.<sup>113</sup> Thus, as one might expect, it would seem that public C corporations fall disproportionately among the higher asset size categories listed in Table 3, the companies with the largest average NOL deductions.

In light of the fact that net operating losses appear to be so prevalent among subchapter C corporations generally, and that public C corporations appear to have large pools of NOL deductions, allowing public firms to be owners of an SPBF will significantly increase the chances that these entities will be used to shift sizable amounts of income and loss around.<sup>114</sup> The pools of losses provide potential sources for very deep tax shelters with minimal transaction costs. Accordingly, public firms taxed under subchapter C should be excluded from the ranks of owners of an SPBF.

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109. See Michael G. Seiders, Corporation Income Tax Returns, 1993, 16 SOI Bulletin 36, 42 (Summer, 1996).

110. Securities and Exchange Commission, Directory of Companies Required to File Annual Reports with the Securities and Exchange Commission Under the Securities Exchange Act of 1934 I (Sept. 30, 1993).

111. The breakdown was 4,611 companies for Nasdaq, 2,362 for the New York Stock Exchange, and 869 for the American Exchange, a total of 7,842 companies or about 61% of the 12,764 10-K forms filed. See Nasdaq Mkt Data web page (visited July 15, 1997) <<http://www.nasdaq.com/>> [hereinafter Nasdaq web page]. The statement assumes that the same company was not traded on more than one of the exchanges.

112. American Stock Exchange, 1994 Fact Book: Equities and Derivative Securities Covering the 1993 Market 16 (1994).

113. For 1997, Nasdaq reported that the average asset size of its companies was just under \$500 million, almost exactly the same average reported by the American Exchange for that year. See Nasdaq web page, *supra* note 111; letter from Scott Slatin, Equity Research and Development, American Stock Exchange, to Peirce Moser (Aug. 6, 1997) (electronically transmitted) (on file with author). In 1994 and since 1988, to be listed on the New York Stock Exchange, a company had to have a minimum of \$18 million in assets. New York Stock Exchange, Fact Book for the Year 1994, p. 35 (1995).

114. Cf. Richard G. Cohen & Lori S. Hoberman, Partnership Taxation: Changes for the '90s, 71 Taxes 882, 883 (1993).

c. *Other Possible Owners.*—In addition to corporations, the subchapter S rules prohibit most other entities from being owners.<sup>115</sup> Clearly, for reasons described above, a private business firm with a public firm owner should not be an eligible SPBF owner. To maintain simplicity and to protect the one class of residual ownership interests rule (described below), most other entities should also be excluded as eligible owners. Exceptions are provided for estates and certain trusts that qualify under current law as an eligible shareholder of an S corporation.<sup>116</sup> As under current law, however, a qualifying trust may not have as a beneficiary any person who is ineligible to be an owner of an SPBF.<sup>117</sup> An SPBF may also have another SPBF as an owner. Thus, for example, a professional partnership some of whose partners are single-member LLCs would satisfy the ownership requirement for an SPBF if the LLC partners themselves qualify as SPBFs.

Congress recently allowed tax-exempt qualified retirement plans under section 401(a) and charitable organizations under section 501(c)(3) to qualify as shareholders of an S corporation so long as the tax-exempt entity's share of S income is taxable as unrelated business income.<sup>118</sup> According to the Senate report—

. . . the present-law prohibition of certain tax-exempt organizations being S corporation shareholders may inhibit employee ownership of closely-held businesses, frustrate estate planning, discourage charitable giving, and restrict sources of capital for closely-held businesses. The Committee seeks to lift these barriers by allowing certain tax-exempt organizations to be shareholders in S corporations. However, the provisions of subchapter S were enacted in 1958 and substantially modified in 1982 on the premise that all income of the S corporation (including all gains on the sale of the stock) would be subject to a shareholder-level income tax. This underlying premise allows the rules governing S corporations to be relatively simple (in contrast, for example, to the partnership rules of subchapter K) because of the lack of concern about "transferring" income to non-taxpaying persons. Consistent with this underlying premise of subchapter S, the

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115. IRC § 1361(b)(1)(B).

116. IRC § 1361(c)(2).

117. IRC § 1361(e)(1)(A).

118. IRC §§ 1361(c)(6) and 512(e), added by the Small Business Job Protection Act of 1996. But see IRC § 512(e)(3), added by the 1997 Act, which repealed the application of the unrelated business income tax to ESOPs that are S corporation shareholders. See Martin D. Ginsburg, *The Taxpayer Relief Act of 1997: Worse Than You Think*, 76 *Tax Notes* 1790 (1997) (demonstrating how § 512(e)(3) may operate to exempt from tax all of the income of an S corporation for an extended period of time).

provision treats all the income flowing through to a tax-exempt shareholder, and gains and losses from the disposition of the stock, as unrelated business taxable income.<sup>119</sup>

The Senate report evidences a desire to increase the flexibility and utility of subchapter S while, at the same time, preserving its relatively simple operating rule structure. These are exactly the same two objectives for an SPBF. However, in contrast to the Congressional decision in 1996, this article concludes that on balance, it would be preferable to exclude such entities as owners, as was the case for subchapter S prior to 1996.

First, allowing such entities to be owners of an SPBF, and taxing them on their share of business income, increases the complexity of the rule structure.<sup>120</sup> Although the flexibility of an SPBF is increased slightly by permitting such owners, it comes with a high price.

Furthermore, there is a simple alternative to permitting exempt owners of an SPBF. If it is truly critical for an exempt entity to participate in a common business venture organized as an SPBF, the taxpayers could form a non-SPBF partnership or other private enterprise taxable as a conduit, with the owners of such entity being the SPBF and the exempt partner.<sup>121</sup> Thus, the business necessity of allowing an exempt entity to be an SPBF owner is far from clear.

Finally, taxing exempt entities on their share of SPBF business income may not eliminate the shifting concerns so central to preserving the simple rule structure applicable to an SPBF. Table 4 provides data on the

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119. S. Rep. No. 281, 104th Cong., 2d Sess. 60-61 (1996), reprinted in 1996 U.S.C.C.A.N. 1474, 1534-35.

120. The peculiar complexities of subchapter K have already started to creep into subchapter S as a result of this 1996 change. Section 170(e)(1) of the Code, as amended by § 1316(b) of Pub. L. No. 104-188, 110 Stat. 1755 (1996), says that when stock of an S corporation is contributed to a charity, "rules similar to the rules of § 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer." In other words, on the occasion of such a contribution, an analysis of the S corporation's assets will have to be made to determine what percentage of them are unrealized receivables and inventory. See generally Testimony of Martin D. Ginsburg, professor of law, Georgetown University Law Center, before the Subcommittee on Taxation of the Senate Finance Committee on S. 758, the S Corporation Reform Act of 1995, 95 TNT 119-19 (June 20, 1995) (LEXIS, FEDTAX library, TNT file) ("the proposal to allow as S corporation shareholders tax-exempt organizations and nonresident aliens is I think unwise. Inevitably, it must add significant complexity to a tax regime a principal justification for which is its relative simplicity in operation"); Small-Business Bill's Subchapter S Provisions Will Spawn More Regs., 72 Tax Notes 965 (Aug. 19, 1996) (rule allowing charities and ESOPs to be eligible S corporation shareholders will cause lengthy IRS regulations project).

121. See Regs. § 1.701-2(d), ex. 2, which explicitly blesses this type of arrangement.

unrelated business income and loss reported by section 501(c)(3), section 401(a), and all tax-exempt organizations in 1993, the latest year for which such data is available. Table 5 then provides data on the net operating loss deductions claimed by such organizations in that year.

Table 4  
Unrelated Business (UB) Income and Loss  
Reported by Section 501(c)(3), Section 401(a),  
and All Tax-Exempt Organizations (1993)

(1) Type of exempt org.	(2) # rets. w/UB inc./loss	(3) # w/ pos. UB inc.	(4) % w/ pos. UB inc. (3)÷(2)	(5) # w/ \$0 UB inc.	(6) % w/ \$0 UB inc. (5)÷(2)	(7) # w/ UB loss	(8) % w/ UB loss (7)÷(2)	(9) Tot. loss (\$ mil)	(10) Avg. loss per loss org. (9)÷(7)
501(c)(3)	9,246	3,191	34.5%	1,204	13.0%	4,851	52.5%	1,001.6	\$206,473
401(a)	1,135	718	63.3%	163	14.4%	254	22.4%	19.4	76,378
All	32,638	15,067	46.2%	4,805	14.7%	12,766	39.1%	1,650.8	129,312

Source: Margaret Riley, Exempt Organization Business Income Tax Returns: Highlights and an Analysis of Exempt and Nonexempt Finances, 1993, 16 SOI Bulletin 75, 91-92 (spring 1997) (Tables 1 and 3). Certain information was obtained directly from Ms. Riley, a statistician in the Special Studies and Publications Branch, Statistics of Income.

Table 5  
NOL Deductions Claimed By Section 501(c)(3),  
Section 401(a), and All Tax-Exempt Organizations  
Reporting Unrelated Business (UB) Income or Loss (1993)

(1) Type of exempt org.	(2) # Rets. w/ UB inc./loss	(3) # Rets. w/NOL ded.	(4) % Rets. w/NOL ded. (3)÷(2)	(5) NOL ded. (\$ M)	(6) Avg. NOL ded. per claim (5)÷(3)
501(c)(3)	9,246	2,516	27.2%	\$ 783.3	\$311,328
401(a)	1,135	313	27.6%	17.8	56,869
All	32,638	6,844	21.0%	\$1,342.8	\$196,201

Source: Margaret Riley, Exempt Organization Business Income Tax Returns: Highlights and an Analysis of Exempt and Nonexempt Finances, 1993, 16 SOI Bulletin 75, 91, 97-98 (spring 1997) (Tables 1 and 7). Certain information was obtained directly from Ms. Riley. The data only reflects net operating losses carried forward to, and deducted in, 1993. Data concerning NOLs carried back to 1993 is not included.

According to Table 4, almost two-thirds of the section 501(c)(3) organizations reporting unrelated business income or loss in 1993 reported either zero income or a net loss for the year.<sup>122</sup> Over half of them reported a net loss, with an average loss per section 501(c)(3) "loss" organization of over \$200,000.<sup>123</sup> The total loss reported by such organizations was just over \$1 billion.<sup>124</sup> Table 5 indicates that more than one-fourth of all section 501(c)(3) organizations reporting unrelated business income or loss claimed a net operating loss deduction from a prior year loss in 1993, with an average NOL deduction per claim of over \$300,000.<sup>125</sup> About \$783 million in such NOL deductions were claimed in that year.<sup>126</sup>

These figures suggest that the tax profile of section 501(c)(3) organizations involved in unrelated business activities may not be markedly different from that of public C corporations. A substantial number of section 501(c)(3) organizations report either no income or losses for tax purposes from their unrelated activities, and although their average claimed NOL deduction is small in comparison with the average NOL deductions of the largest taxable corporations, the deductions are nevertheless significant in size.<sup>127</sup> Like their corporate counterpart, those deductions could provide ample shelter opportunities in any given case.

Perhaps these conclusions should not be surprising; after all, if an exempt organization is taxed on its unrelated business activities in the same manner as a taxable corporation, then one might expect a similar resulting tax profile to those corporations. Indeed, some have suggested that the tax rules for computing unrelated business taxable income are more favorable than for calculating taxable income generally because the former may allow the deduction against unrelated business income of expenses attributable to the exempt function of the organization.<sup>128</sup> Obviously, the more favorable the

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122. Table 4, cols. (6) and (8), line 1.

123. Table 4, cols. (8) and (10), line 1.

124. Table 4, col. (9), line 1.

125. Table 5, cols. (4) and (6), line 1.

126. Table 5, col. (5), line 1.

127. Compare Table 3, col. (7), lines 10-12 with Table 5, col. (6), line 1. In addition, just like the other data on NOL deductions, the figures in Table 5 do not include loss carrybacks to 1993. See Margaret Riley, *Exempt Organization Business Income Tax Returns: Highlights and an Analysis of Exempt and Nonexempt Finances, 1993*, 16 SOI Bulletin 75, 84 (Spring, 1997). Thus, the actual NOL deductions of exempt organizations are larger than the numbers shown in columns (5) and (6) of Table 5.

128. See U.S. House Ways and Means Oversight Subcommittee UBIT Recommendations (draft), reprinted in 88 TNT 132-5 (Jun. 24, 1988) (LEXIS, FEDTAX library, TNT file) ("there has been evidence of excessive, and in some cases possibly abusive, allocations to taxable uses of various expenses . . . attributable to [facilities used for both exempt and nonexempt purposes]. In these cases, net income from taxable activities may be greatly reduced or completely eliminated simply through liberal expense allocations."). For additional



tax rules, the greater the possibility of generating losses for tax purposes. In any event, whatever the explanation, it would seem that for the same reasons that public C firms are excluded as owners of an SPBF, section 501(c)(3) organizations should also be excluded.<sup>129</sup>

The case for excluding taxpayers qualifying under section 401(a) is less clear. As shown on Tables 4 and 5, fewer of them than section 501(c)(3) organizations report losses, and the average amount of losses reported and net operating loss deductions claimed is much less.<sup>130</sup> On the other hand, the issue of permitting them to be an SPBF owner may not be very significant, as only 1,135 section 401(a) organizations reported any unrelated business income or loss at all in 1993,<sup>131</sup> and just a fraction of them reported income from partnerships and therefore might be expected to be potential owners of an SPBF in the future.<sup>132</sup> Therefore, for the other reasons stated above, it seems preferable to exclude them as owners as well.

In summary, exempt entities are treated like almost all other entities and are excluded from ownership of an SPBF.

Much the same reasoning supports excluding nonresident aliens as owners of an SPBF. Ascribing the firm's activities to the nonresident alien, as in the case of a foreign partner in a partnership or a foreign beneficiary of a trust or estate engaged in a trade or business in the United States,<sup>133</sup> thereby creating a trade or business in the United States for the foreigner and serving as a basis for taxing the foreign person on the U.S. profits of the enterprise, would add complexity to the SPBF structure. There would also be the administrative problem of collecting any resulting tax on undistributed income from the foreign person.<sup>134</sup> In addition, the business necessity of

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discussion of this issue, see John Copeland & Gabriel Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 *Tax Notes* 747, 752-53 (1986); Thomas A. Troyer, *Changing UBIT: Congress in the Workshop*, 41 *Tax Notes* 1221, 1224 (1988).

129. The charities reporting unrelated business income or loss are, of course, just a small fraction of the roughly 500,000 nonprofit charitable organizations recognized by the IRS under § 501(c)(3). But the tax profile of that small subset of charities is very relevant to this analysis. The most likely charities to own an SPBF in the future, if the rules allow it, are those that have previously served as partners in partnerships, and therefore have received and reported unrelated business income.

130. See Table 4, cols. (8) and (10), compare lines 1 and 2; Table 5, col. (6), compare lines 1 and 2.

131. See Table 4, col. (2), line 2.

132. Only 2,690 exempt organizations out of the 32,638 reporting any unrelated business activities in 1993, about 8%, reported income or loss from partnerships. See Riley, *supra* note 127, at 95 (Table 6, col. (11)).

133. IRC § 875(1) and (2).

134. Section 1446(a) requires a partnership with effectively connected income and a foreign partner to pay a withholding tax on the portion of such income allocable to the foreign partner. The withholding tax obligation arises regardless of whether there is any

permitting foreigners to own an SPBF is not clear, in view of the alternative means available to accomplish that investment objective.<sup>135</sup> Finally, a foreigner who is in a low U.S. income tax bracket may nevertheless be a "high-bracket" taxpayer if worldwide income is considered, in which case assumptions regarding the lack of financial sophistication of such a taxpayer would be inapplicable. For these reasons, as is true for existing subchapter S, nonresident aliens are excluded as eligible owners of an SPBF.<sup>136</sup>

d. *Summary.*—In summary, individuals other than nonresident aliens may be owners of an SPBF. The only other permissible owners are estates, trusts that are allowed to be shareholders of an S corporation under current law, and other SPBF firms. Public firms taxed under subchapter C may not be owners of an SPBF.

2. *Only One Class of Residual Ownership Interests.*—Although the ownership restrictions for an SPBF are designed to insure that most owners have roughly the same tax profile and therefore cannot easily benefit from income and loss shifts between one another, such rules are not effective at precluding strategic shifts of categories of income and loss and other tax items. For example, two high-bracket owners would not ordinarily benefit from shifting ordinary income from one to the other. But if one owner had unused capital losses and the other did not, the two owners might both benefit from a shift of capital gains to the owner with the capital losses.

The availability of strategic shifts involving particular categories of tax items is limited, however, if all ownership interests of an SPBF have identical rights to income, loss, distributions, and liquidation proceeds of the firm and the allocation of all tax items has to be done in the same straight-up manner in accordance with the per-day, per-interest share of each owner.<sup>137</sup> In effect, such a rule eliminates the possibility of item allocations. All tax items would have to be allocated in the same way. Thus, a one-class-of-ownership-interest rule may be a useful complement to the ownership restrictions of an SPBF to restrict the availability of shifting strategies within an SPBF.

Another reason to include such a requirement is to reduce the complexity of the SPBF operating rules. The one-class-of-stock rule in the

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distribution to the foreign partner and whether the partnership's income is reflected in cash. The provision, enacted in 1986, requires the tax to be paid in accordance with Treasury regulations, which to date, have not been issued.

135. See *supra* note 121 and accompanying text.

136. A proposal to make them eligible was not included in the Small Business Job Protection Act of 1996.

137. Cf. Regs. § 1.1361-1(l)(1).

subchapter S area has been explained as "prevent[ing] complexities in attributing the corporate distributions to the various shareholders."<sup>138</sup> Those complexities certainly do exist in the rules applied to partnerships, trusts and consolidated groups, none of which imposes restrictions on ownership classes. As just one example, the partnership rules contain strict and extensive requirements regarding the maintenance of the capital accounts of the partners in order to validate the special allocations of the partners, whereas the S corporation rules have no comparable requirement. In the ideal, the SPBF rules would not require owners of the firm to maintain capital accounts in any particular way.

On the other hand, if the SPBF eligibility conditions are too restrictive, they would be contrary to the objective of providing a simplified rule structure to as many private business firms as possible. Thus, it is not clear that an SPBF would have to have only a single class of ownership interests as that concept is interpreted under existing subchapter S.

Consider, for example, two taxpayers, A and B, who decide to contribute \$5,000 each to a common business venture. A would like a relatively certain and safe return on his or her investment with the understanding that there will be little or no upside potential beyond that safe return. B is willing to go along with A's request and to assume the risk of all losses beyond the amounts contributed so long as B will garner all of the upside potential in excess of the return belonging to A. Under current law, the two investors can utilize an S corporation only if A's investment is treated as debt rather than equity.<sup>139</sup> If, for good business reasons such as the insistence of a third-party lender to the firm, a loan from A is not feasible, then an S corporation cannot accommodate them; they would have to form a partnership or other unincorporated entity and be taxed under subchapter K.<sup>140</sup>

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138. *Barnes Motor & Parts Co. v. United States*, 309 F. Supp. 298, 301 (E.D. N.C. 1970); see also *Paige v. United States*, 580 F.2d 960, 963-64 (9th Cir. 1978). The *Barnes* opinion suggests that all the restrictions in § 1361(b)(1) can be explained on this basis. That includes the number of shareholders, the prohibition of a shareholder who is not an individual, and the prohibition of a nonresident alien shareholder. See also *supra* note 83.

139. See IRC § 1361(c)(5) (straight debt not considered second class of stock).

140. The granting of compensatory options to shareholder-employees of the S corporation is one way of achieving some flexibility within the constraints of the S corporation's one-class-of-stock rule. See James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations* ¶ 6.04 (3d ed. 1993); Berger, *supra* note 63, at 141. The regulations specifically bless certain forms of such options. See Regs. § 1.1361-1(d)(4)(iii)(B)(2). On the other hand, the regulations indicate that if the State Corporation Commissioner imposes a restriction on the distribution rights of certain shareholders, the restriction may constitute a second class of ownership and therefore prevent qualification as an S corporation. See Regs. § 1.1361-1(d)(2)(v), ex. (1); *Paige v. United States*, 580 F.2d 960 (9th Cir. 1978). Permitting the firm to issue a class of straight preferred ownership interests would overcome that obstacle.

One method of accommodating the foregoing business arrangement would be to allow the entity to issue the equivalent of plain vanilla preferred stock.<sup>141</sup> The proposal would permit a class of ownership interests to be issued with a clear priority over the only other class of interests, and return on the preferred class would be fixed and limited to the earnings of the entity. In the foregoing example, A might own all of the preferred interests and be allocated the first slice of entity income. B would own all of the remaining, residual interests, and be allocated any losses of the firm and all income beyond the initial slice belonging to A.

Could the existence of two classes of ownership interests, one with clear income priority over the other, be manipulated by the parties? One possible concern might be the "skimming" of income to part-year owners. Consider a calendar year firm that issues a new class of preferred interests on December 31. If there is nothing to limit the amount of income that could be allocated to the one-day owner of the preferred interest, the newly-issued interest would allow manipulation of the firm's income for the year. In an extreme case, the preference could be such that all of the firm's income for the year would be allocated to the new owner and away from the holders of the residual interests.<sup>142</sup>

But a similar problem arises under existing subchapter S and, as a result, section 1377 requires the firm to divide up its income pro rata among the days of the year. Thus, one who acquires all of the stock in an S corporation under existing law on the last day of the year cannot be allocated all of the corporation's income for the year. As long as the preferred class of ownership interests is restricted in the same way, the possibility of manipulation from such a maneuver appears to be reduced or eliminated.<sup>143</sup>

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141. Such a proposal was included in the "S Corporation Reform Act of 1995," S. 758, reproduced at 95 TNT 88-5 (May 5, 1995), § 121 (LEXIS, FEDTAX library, TNT file). However, it was not part of the subchapter S liberalizations contained in the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).

142. The "S Corporation Reform Act of 1995," S. 758, reproduced at 95 TNT 88-5 (May 5, 1995) (LEXIS, FEDTAX library, TNT file), as drafted, appears to have allowed for such manipulation. It would have added § 1361(c)(8) to the Code, under which distributions on qualified preferred stock (stock described in § 1504(a)(4)) would have been treated as interest payments. There is no indication that the holder of the stock on the record date would not have been credited with the full amount of interest no matter how short a time period the stock had been held. In any event, this provision did not become part of the Small Business Job Protection Act of 1996.

143. Income of the entity would *first* be allocated to each day of the taxable year. Hence, if an owner acquires all of the preferred interests on the last day of the year, that owner can get allocated at most all of the income of the entity allocated to that day. That result would occur no matter how great the preference of the ownership interest. At most, an interest with a large preference could be allocated all the firm's income earned for the year properly allocable to the period that the interest was outstanding.

Other concerns relate to the character of income allocated to the preference holder. For example, suppose A is provided a preferential interest equal to the first \$1,000 of the firm's income, with any additional income and all losses to be shared equally by A and B. Suppose during the year, the firm has only \$1,200 of capital gain income, a fact reasonably known to the parties at the time the preferential interest was created. Should A's preference then mean that A is allocated \$1,100 and B \$100 of the firm's capital gains for the year? If so, it is evident that the strategic utilization of preferential interests could easily permit the equivalent of special item allocations.<sup>144</sup>

To avoid such possibilities and to be consistent with the "debt-like" characterization of the preferred interest, any income allocated to the preference holder should be treated as ordinary income with the firm being provided with an ordinary deduction.<sup>145</sup> The preference should not in any other respect affect the amount or character of tax items allocated to the owners of the firm.<sup>146</sup> Thus, in the above example, A would be allocated \$1,000 of ordinary income and would share equally with B in the \$1,200 of capital gain and the \$1,000 ordinary deduction of the firm. The tax result would be the same as if A had loaned funds to the firm and been entitled to a \$1,000 interest payment that year.

If the firm has enough income to support the preference but does not distribute the full preferred amount, one possible rule would be to defer the tax consequences of the unpaid amount until payment.<sup>147</sup> Alternatively, the

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144. Moreover, if the firm had, say, \$1,200 of capital gains and \$800 of ordinary income for the year, what should be the character of A's income preference?

145. Section 201 of S. 758, the "S Corporation Reform Act of 1995," supra note 141, would have imposed this requirement with respect to its qualifying preferred stock interest.

146. *Id.* at § 201(b)(2) (holders of preferred stock not allocated any of the S corporation's § 1366(a)(1) items).

147. This treatment would be consistent with an idea long advocated by Professor Eustice in connection with subchapter S. Professor Eustice would permit an S corporation to have a single class of common stock and any number of classes of preferred stock, including participating preferred (which he would treat as preferred stock, and not common, in his allocation scheme). Dividends actually paid on the preferred stock would be taxable as ordinary income to the shareholders without regard to the corporation's earnings or profits or other indication of income, and the corporation would be allowed to deduct the amount of dividends actually paid. Thus, he would place both shareholders and the corporation on the cash method of accounting with respect to dividends. The corporate dividends-paid deduction could not, however, create a loss; the excess of such a deduction over corporate income would have to be carried forward within the entity. Other losses and any remaining income of the firm would be passed through to the common shareholders on a per-day, per-share basis. See James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 *Tax L. Rev.* 345, 366 (1984) (a single class of preferred stock); Eustice & Kuntz, supra note 140, at ¶ 1.03[2][b][v] (multiple classes); see also Berger, supra note 63, at 141 (endorses Eustice and Kuntz proposal); ABA Section of

allocation of ordinary income (with accompanying ordinary deduction for the firm) might take place in the current year, as would generally be true in the case of a deferred payment of interest.<sup>148</sup> In that case, if the preference is not satisfied by the time the holder terminates his or her investment in the firm, then the tax treatment would be the same as cancellation of a debt obligation—the preference holder would be entitled at that time to a bad debt deduction and the firm would have cancellation of indebtedness income.

Other possible manipulative uses of a preferred interest would be mitigated by the ownership restrictions of an SPBF. Suppose, for example, that preferred interests and residual interests of the same firm could be exchanged tax-free, either directly in a tax-free recapitalization or indirectly through a combination of contributions and distributions. The special allocation rules in the partnership area basically permit tax-free exchanges because allocations can be changed from one year to the next without tax consequences. Ordinarily, if investors A and B could change their positions as preferred and residual interest holders from one year to the next without tax consequences, then important tax advantages might result. But the extent of the advantage would depend upon how different the investors' tax profiles are, something the ownership restrictions are designed to restrict.

In summary, the proposal merely limits an SPBF to having only one class of *residual* ownership interests. Every outstanding interest in the residual class must confer identical rights with respect to income, loss, distributions, and liquidation proceeds of the firm. Multiple classes of preferred interests are permissible provided that a clear order of priority for the different preferred interests is established. All preferences should constitute ordinary income to the preference holder and generate an ordinary deduction to the firm. Any income of the firm not allocable to the preferred interests, and all losses of the firm, are allocable to the class of residual interest holders in a proportional manner based on their percentage interests and the number of days in the year they owned such interests.

3. *Other Eligibility Conditions Not Proposed.*—Several other possible eligibility conditions for an SPBF were considered in addition to, or in some cases as substitutes for, the ones described above. This section briefly describes why they are not included in the proposal.

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Taxation Committee on S Corporations, Report on the Comparison of S Corporations and Partnerships (Part I), 44 Tax Law. 483, 494 (1991) (single class of stock requirement should be altered).

148. See IRC § 1272(a). Similarly, a guaranteed payment which is deducted or capitalized by a partnership must be included currently in the income of a cash-basis partner even though the amount is unpaid. See William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 13.03[2] (3d ed. 1997).

a. *Number of Owners.*—There is no restriction on the number of permissible owners for a partnership, RIC, REIT, REMIC, FASIT or cooperative.<sup>149</sup> In contrast, an S corporation may not have more than 75 shareholders.<sup>150</sup> The IRS has indicated that the purpose of the limitation on the number of shareholders of an S corporation is “administrative simplicity in the administration of the corporation’s tax affairs.”<sup>151</sup> The Service has nevertheless allowed a number of S corporations to join together in a partnership even though that arrangement could be viewed as a way to avoid the limitation on the number of shareholders in an S corporation (and, indeed, was so viewed by the IRS at one time).<sup>152</sup>

A major source of complexity in subchapter K is the allocation rules which attempt to prevent the inappropriate shifting of tax items among owners of a firm. In contrast to the eligibility conditions for an SPBF already identified, it does not appear that the availability of shifting strategies is affected by the number of participants in the enterprise. True, the greater the number of owners, the greater the potential that taxpayers with distinctly different tax profiles will participate together in a common venture. But important tax advantages may exist even though a firm has only two owners. And the fewer the number of owners, the greater the flexibility in devising an advantageous shifting strategy.

Moreover, as a practical matter, very few private businesses have a large number of owners. For example, in 1994, over 90% of all partnerships and almost 99% of all S corporations had 10 or fewer owners,<sup>153</sup> and comparable figures seem likely for closely-held C corporations. Thus, any reasonable limitation on number of owners would not likely have much impact on SPBF eligibility.<sup>154</sup>

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149. A FASIT may have only one holder of its ownership interest but any number of holders of its regular interests. IRC § 860L(a)(1)(B) and (C).

150. IRC § 1361(b)(1)(A), as amended by the Small Business Job Protection Act of 1996.

151. Rev. Rul. 94-43, 1994-2 C.B. 198.

152. *Id.*; cf. Regs. § 1.701-2(d), ex. (2) (blessing partnership between nonresident alien and S corporation to avoid restrictions of § 1361(b)(1)(C)). The Service’s prior contrary position was stated in Rev. Rul. 77-220, 1977-1 C.B. 263.

153. In 1994, about 68% of all partnerships and 90% of all S corporations had three or fewer owners. For the S corporation data, see Susan M. Wittman, *S Corporation Returns, 1994*, 16 SOI Bulletin 38, 74 (Spring 1997) (Table 5). The information about partnerships was obtained in a telephone conversation between the author and Mr. Tim Wheeler, a statistician in the Corporation Special Projects Section, Statistics of Income, Internal Revenue Service.

154. Congress’s recent amendment of the subchapter S rule provides no guidance regarding what the proper limit on the number of owners should be, assuming one is imposed. Congress tersely explained its reasons for increasing the allowable number of S shareholders from 35 to 75 in the following way: “The Committee believes that increasing the maximum number of shareholders of an S corporation will facilitate corporate ownership by additional

In short, any limitation on the permissible number of owners of an SPBF would seem to be an arbitrary and ineffectual restriction insufficiently linked to the availability of potential tax advantages of such a firm, and is therefore not proposed.

b. *Ownership of Other Entities.*—Until recently, the S corporation rules prohibited an S corporation from being part of an affiliated group.<sup>155</sup> Since S corporations may not have corporate owners, the major effect of this rule was that S corporations could not own more than 80% of the stock of another corporation (unless it was an inactive corporation). On the other hand, S corporations were permitted to be partners in partnerships, to be members of cooperatives, and to own stock in RICs and REITs. The restrictions on stock ownership by S corporations have now been repealed, although S corporations are prohibited from filing consolidated returns.<sup>156</sup> S corporations are now also allowed to be 100% owners of other S corporations, which are then not treated as separate entities.<sup>157</sup>

RICs and REITs are limited in the amount of their assets that can be invested in particular companies.<sup>158</sup> The rules applicable to RICs and REITs, however, are not functions of the conduit nature of those entities. Rather, they relate to their roles as investment vehicles for relatively small investors, and a securities law concern that such vehicles be sufficiently diversified so as not to be too risky for such investors.<sup>159</sup> Consistent with Congress's recent change regarding S corporations, there does not seem to be any reason to impose any restrictions on the particular type of entity an SPBF may own.

c. *Nature of Income.*—Eligibility for certain pass-through entity regimes under current law is conditioned on the nature of the firm's income or business activities. But the significance of a firm's passive or

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family members, employees and capital investors." S. Rep. No. 281, 104th Cong., 2d Sess. 45 (1996), reprinted in 1996 U.S.C.C.A.N. 1474, 1519. Congress's reasoning may justify a number greater than 35, but doesn't explain the reason for stopping at 75.

155. See former IRC § 1361(b)(2)(A), repealed by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1308(a).

156. See IRC § 1504(b)(8), added by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1308(d)(2) (excepts S corporations from the definition of "includible corporation"). This change tracks a suggestion made by Professor Eustice. See Eustice, *supra* note 147, at 360.

157. See IRC § 1361(b)(3), added by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1308(b).

158. See IRC §§ 851(b)(4) and 856(c)(5)(B).

159. The relevant provisions are referred to as diversification of investment requirements. See Regs. §§ 1.851-2(c) and 1.856-2(d).



active income or business activity is not coherent across the different tax regimes. For a trust to be classified as such, it cannot be engaged in an active business. In the past, failure to qualify as a trust would probably have doomed the trust to be taxed as a corporation, but that is no longer true under the check-the-box classification regulations.<sup>160</sup> On the other hand, S corporations with earnings and profits from their operations as C corporations are currently subject to tax if they have excessive passive income.<sup>161</sup>

Most income of RICs must come from investment sources,<sup>162</sup> and the income of REITs must come substantially from real estate investments that must be relatively passive in nature.<sup>163</sup> REMICs are generally limited to holding mortgages and other passive investments,<sup>164</sup> and FASITs are similarly limited to certain short-term debt instruments.<sup>165</sup> Partnerships generally have no limitation on the type of income that they can earn, except that partnerships with publicly traded ownership interests escape corporate classification if 90% or more of their gross income consists of certain categories of "qualifying income."<sup>166</sup>

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160. Although the former classification regulations provided that an entity that failed trust classification could be classified as either a partnership or an association, see former Regs. § 301.7701-4(b), the four factor test usually resulted in entities formed as trusts being classified as corporations. Trusts would generally have limited liability, free transferability of interests, and centralized management, and would be classified as associations with those three corporate characteristics. The check-the-box regulations treat failed trusts as "business entities," and therefore permit them to make an explicit entity classification election for tax purposes. See Regs. § 301.7701-4(b).

161. See IRC § 1375.

162. IRC § 851(b)(2) provides that at least 90% of the gross income of a RIC for any taxable year must be from dividends, interest, payments with respect to security loans, and gains from the sale of stocks, securities, foreign currency, or other investment income. Since failure to satisfy this requirement would cause the RIC to be disqualified, the management of a RIC is likely to stay comfortably above the 90% line. RICs are subject to additional restrictions, including those relating to the assets they hold, see IRC § 851(b)(4), as well as restrictions imposed on them so that they can comply with the Investment Company Act of 1940.

163. The income restrictions applicable to REITs can be found in IRC § 856(c)(2) and (3). Key to the limitation on the REIT income are the restrictions applicable to "rents from real property" that are found in IRC § 856(d). Excluded from "rents from real property" are rents that are based on a tenant's income or profits, and rents received when the REIT (as opposed to an independent manager) provides services to the tenants or runs the property, see IRC §§ 856(d)(2)(A), (C).

164. See IRC §§ 860D(4) and 860G(a)(3) and (5).

165. See IRC §§ 860L(a)(1)(D), (c)(1).

166. See IRC § 7704(c)(1). "Qualifying income" is generally passive-type income although it also includes certain potentially active income from businesses engaged in the extractive industries. See IRC § 7704(d)(1).

As can be seen from the foregoing brief review, there are contradictory views of the importance of passive or active income or business activities in the context of pass-through entities. Do the various conditions of current law provide any basis for imposing similar restrictions on the nature of an SPBF's income or activities?

Perhaps the reason for the special rules in the trust area is a problem unique to that form of entity—the problem of taxing income to unknown beneficiaries, such as an unborn child. One author has suggested that, in such a situation, a withholding tax should be imposed on the entity at the highest individual tax rate, and that the law, through relatively mechanical rules, would then determine which potential beneficiary is the proper taxpayer.<sup>167</sup> That “taxpayer” can then take a credit (with the possibility of generating a refund) in respect of the trust's prior withholding tax payment. In other words, the trust would be subject to a temporary entity tax with a relief mechanism to avoid double taxation. The proposal helps to bring the taxation of trusts and estates closer to the taxation of other pass-through entities.

The nature-of-income limitations for RICS, REITs, REMICs, FASITs, and publicly traded partnerships may simply be part of the tax law's condition for permitting such publicly traded entities to obtain pass-through treatment. In addition, there may be securities law reasons for some of the limitations. If there were no such limits, the pass-through regime could become the norm for all businesses—for example, General Motors could become a RIC. Because there is no consensus regarding why the income of public firms should be taxed twice, it is not surprising that the exact nature of these restrictions cannot be explained from first principles. Instead, one might simply conclude that a limitation may be needed in order to maintain the integrity of the double tax system as applied to public firms, whether such a system can be justified or not.

In the S corporation context, the rules of section 1375, which restrict the ability of S corporations to receive passive income, raise issues that are essentially transitional in nature. An S corporation with no C corporation history will not run afoul of this rule.

In conclusion, there is no apparent reason to limit the nature of income or business activity of an SPBF. Existing restrictions applicable to other entities seem designed to either protect the double taxation of the income of public firms, protect transitional concerns when a double-taxed entity is converted into a single-taxed one, or respond to features peculiar to that entity. Because these explanations are not applicable to an SPBF, no such restrictions are included in the proposal.

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167. Sherwin Kamin, *A Proposal for the Income Taxation of Trusts and Estates, Their Grantors, and Their Beneficiaries*, 13 *Am. J. Tax Pol'y* 215 (1996).

d. *Size of Enterprise (Measured by Assets, Sales, Income, or Some Other Measure).*—The tax statute is littered with past Congressional efforts to provide special treatment for “small businesses.” These provisions are in addition to the many special rules applicable only to subchapter S corporations. Most of the provisions define small businesses in terms of gross receipts, but assets and other tests have been employed as well.<sup>168</sup>

In addition to its other eligibility conditions, should an SPBF be limited by size? From the Treasury’s perspective, smaller enterprises generally present tax issues of only limited significance. Thus, if a more relaxed set of operating rules eliminating some of the protective features of subchapter K is to be provided to a subset of firms, it might make sense to limit the availability of those rules to small businesses.

From the taxpayer’s vantage point, small businesses are likely to have less sophisticated owners and advisors than larger businesses. Therefore, small businesses would particularly benefit from a simplified tax rule structure. Although larger businesses would also benefit from simplification, they might have alternative means not available to smaller businesses of coping with tax law complexity.

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168. See, e.g., IRC §§ 44(b) (business with gross receipts not exceeding \$1 million or one having no more than 30 full-time employees), 55(e)(1) (corporation with average annual gross receipts for three preceding years not exceeding \$5 million (or \$7.5 million after 1997)), 447(d) (gross receipts not exceeding \$1 million or, in certain cases, \$25 million), 448(c) (average annual gross receipts for three preceding years not exceeding \$5 million), 474(c) (same), 6721(d)(2)(A) (same), 263A(b)(2)(B) (average annual gross receipts for three preceding years not exceeding \$10 million), 460(e)(1)(B) (same), 613A(d)(2) (certain gross receipts may not exceed \$5 million), 508(c)(1)(B) (gross receipts normally not more than \$5,000), 6033(a)(2)(A)(ii) (same), 6113(b)(2)(A) (gross receipts normally not more than \$100,000), 1044(c)(3) (any partnership or corporation licensed by the SBA under § 301(d) of the Small Business Investment Act of 1958), 1202(d)(1) (gross assets not exceeding \$50 million), 1244(c)(3) (shareholder contribution, including paid-in surplus, not exceeding \$1 million), 243(a)(2) (must be small business investment company operating under the Small Business Investment Act of 1958), 246A(b)(2) (same), 582(c)(2)(A)(iii) (same), 1242 (same), 1243 (same), 542(c)(8) (same, except that firm must be actively engaged in business of providing funds to small business concerns), 220(c)(4) (average of 50 or fewer employees during either of two preceding calendar years), 4980D(d)(2) (average of at least two but not more than 50 employees during preceding calendar year), 6053(c)(4) (10 or fewer employees during preceding calendar year). Certain other provisions are designed to be limited to small businesses through a phase-out or other mechanism. See, e.g., IRC §§ 11(b) (phase-out of low brackets for corporations with higher income), 179(b)(2) (phase out of § 179 expensing benefit where amount of § 179 property placed in service begins to exceed \$200,000), 195 (special rule limited to “start-up expenditures”). Similar rules have been included in recent proposals. See, e.g., Treasury Integration Report, *supra* note 28, at 42 (businesses with gross receipts less than \$100,000 not subject to CBIT); Berger, *supra* note 63, at 165 (distinguishes one-tier from two-tier entities based on their total revenues, with the dividing line between \$10 million and \$50 million).

One problem with a "small business" condition is developing a proper definition for that term. A dollar-size rule establishes a bright line, but it is unclear whether a dollar-size limit should apply to assets, receipts, taxable income, some combination of the foregoing, or something else. "Receipts" seem to draw too arbitrary a line between capital-intensive and service-based firms; such a distinction appears unrelated to either the tax advantage potential of the firm or its need for a simple operating rule structure. "Taxable income" is probably too inaccurate a proxy for "small business." In addition, "taxable income" presents the greatest boundary problems, given how common it is for business income to fluctuate from year to year.<sup>169</sup> An asset-based test is reasonably stable and somewhat representative of "small business," yet it entails the potential disadvantage of requiring periodic valuations.<sup>170</sup> It also may arbitrarily distinguish service businesses from others.<sup>171</sup> In short, any test for small business seems either too arbitrary or unworkable, and prior efforts to define small business for tax purposes do not appear helpful.

Another problem with a rule providing preferential treatment to small businesses is the need to prevent division of a single enterprise into parts small enough to qualify for that treatment. A number of existing provisions undertake to accomplish this task, but none seems consistent with a goal of keeping the system simple.<sup>172</sup> A further concern of any dollar-size rule is the boundary problem created: how should firms be treated when they flip-flop onto different sides of the applicable dollar threshold?

A more fundamental concern is that any dollar size rule would exclude too many firms. Some larger firms, used to the relative simplicity of subchapter S, would be forced to be taxed under more complex conduit rules such as subchapter K. Although a larger firm willing to engage in a less

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169. See Berger, *supra* note 63, at 162-63.

170. The proper treatment of debt is also problematic under an asset-based test. See Berger, *supra* note 63, at 163. One possible way of reducing the valuation burden is to value a firm as of the last noncash contribution to or distribution from the entity, when some value for the firm was presumably agreed to by the parties, adjusted by the book value of any net accumulations since that time. But such a rule seems to ignore substantial value, such as the value of any asset appreciation of the firm since the time of the last noncash contribution or distribution. In addition, the rule appears to permit the firm to transact a very large economic deal and still qualify under the applicable dollar test so long as there is a contemporaneous distribution of the proceeds of the deal to the owners of the firm. That outcome does not seem consistent with a small business limitation to the SPBF rules.

171. See Timothy D. Wheeler, Partnership Returns, 1994, 16 SOI Bulletin 76, 78 (Fall 1996) (Figure D) (setting forth net income, total receipts, and total assets of partnerships by industry).

172. See, e.g., IRC §§ 44(d)(2) and (3), 220(c)(4)(D), 474(d)(1), 1202(d)(3); cf. IRC § 1561.

flexible business arrangement can always obtain a fairly simple tax regime within the confines of regular subchapter K, it is much easier for taxpayers to proceed under a prepackaged set of simple tax operating rules than to tailor their own set to accommodate their individual business needs. If the theory of the other eligibility conditions of an SPBF is sound, then the size of the enterprise should not matter. In that regard, the subchapter S rules have never included a size-of-enterprise limitation.

Some thought was also given to using a dollar size test as the exclusive eligibility condition for firms entitled to a simpler set of tax operating rules. The theory is that firms under a certain economic size do not likely comply with a more rigorous set of rules anyway; the IRS is not likely to discover whether they do or do not comply; and their small size makes any resulting tax advantage to the owners a relatively modest concern to the Treasury. Hence, a highly simplified operating rule structure could be provided to such firms without much effect on the fisc.

Such an approach would, of course, place considerable pressure on the definition of "small business" in order to prevent large firms or economic deals from obtaining the greater tax advantages presumably available under the simple version of subchapter K. Moreover, even a foolproof definition would apparently not preclude wealthy and sophisticated taxpayers from engaging in small economic deals through such small business firms, thereby obtaining certain tax advantages not otherwise available. Thus, a market of SPBF tax shelters might develop for the middle and upper income taxpayer. This concern might be alleviated if the dollar size limitation is low enough to make purely tax-motivated transactions uneconomic, but of course, an excessively low threshold would then exclude a number of deserving firms.

Finally, a nagging concern about such an approach is whether it would ultimately result in any practical benefit to anyone, including particularly the small economic firms to which the rules would be targeted. Given the complexity of subchapter K, the lack of significant IRS auditing of firms subject to those rules, and the general feeling that large parts of subchapter K are misapplied even by very knowledgeable practitioners, it may well be that many small firms (as well as some not so small ones) already utilize a watered-down, intuitive version of subchapter K. This "intuitive K," which is surely different things to different people, may well continue to govern the world of small firms (and some large ones), regardless of what this article might propose and what the Congress might someday enact. If so, then a simplified operating rule structure limited to small economic firms may ultimately be nothing more than an attractive nuisance for which some sophisticated practitioners may find improper uses.

For all of the foregoing reasons, the proposal does not contain any test based on the size of the enterprise.

### C. Operating Rule Provisions of the Simplified System

This section sketches out the principal operating rule provisions for the SPBF system.

1. *Explicitly Elective System.*—The SPBF operating rules to be described should be explicitly elective to qualifying taxpayers. Because the rules are intended to be more administrable than subchapter K generally, some thought was given to making the rules mandatory for qualifying firms. In theory, a mandatory rule would eliminate the cost to taxpayers of determining whether and how to elect the rules and would promote greater use of the simplified SPBF system.

In reality, however, a mandatory rule may not achieve either objective. Even without an explicit election, well-advised taxpayers may nevertheless attempt to determine whether the simplified system is more favorable to them than the default operating rule system. To avoid the SPBF rules, a taxpayer need only fail one or more of the eligibility conditions for an SPBF. In that sense, the SPBF rules are elective one way or the other, and there seems to be no good reason to force taxpayers to utilize transactional devices to avoid them. Hence, the proposal provides for an explicit election.

Because some taxpayers, including certain smaller, unsophisticated firms for which the SPBF rules are specifically designed, may not be aware of the existence of an election or may fail to comply with whatever procedure is established for executing it, the proposal provides only for a permissible election by any SPBF *out of* the simplified conduit version. A failure to elect automatically means the SPBF is taxed under the simplified system.<sup>173</sup>

The subchapter S election under current law is different from the above. Eligible corporations must affirmatively elect into subchapter S and all shareholders must consent to the election.<sup>174</sup> Failure to make the S election means the corporation is taxed as a separate entity under subchapter C. Presumably, Congress wanted to avoid surprising shareholders regarding the effect of the conduit election of subchapter S, with the accompanying counterintuitive obligation on their part to report their share of *undistributed* items in the current year.<sup>175</sup> Hence, it makes sense to require an affirmative S election under current law. This article recommends, however, that *all* private business firms shall be taxed as conduits. If that recommendation is

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173. Both the installment sales and entity classification elections operate in this fashion. See IRC § 453(d); Regs. § 301.7701-3(b)(1). Despite this feature, this article still refers to the non-SPBF conduit system as the “default system.”

174. See IRC § 1362(a).

175. See James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 *Tax L. Rev.* 345, 369 (1984).

adopted, then the norm will be for all owners of private firms to report currently their share of passthrough items, including undistributed items, and the consequences of the simplified conduit version should therefore not be a surprise.

Finally, the elective nature of the SPBF rules emphasizes again the importance of achieving the proper balance in the substantive outcomes under the SPBF and default operating rule systems.

## 2. *Passthrough Scheme; Allocations of Tax Items and Debt of the Firm*

a. *In General.*—The proposal adopts the basic passthrough structure common to partnerships and S corporations under current law. All tax items of an SPBF are allocated among the owners of the firm who must include such items in determining their income tax liabilities. The character of each item is determined at the firm level, with that character then passed through and reported by the owners. Owners must take into account their share of the firm's tax items in their taxable years in which the firm's tax year ends. Because no limitation is placed on the nature of an SPBF's income or activities, the tax items to be passed through to the owners should be the same as those listed in section 702(a) of the Code. If some simplified passthrough scheme can be devised where fewer categories of items need to be separately stated and passed through, that simplified rule would apply to an SPBF as well.

Like an S corporation, an SPBF is generally not permitted to make special allocations. To accomplish that objective, the SPBF proposals limit the firm to having only one class of residual ownership interests and generally require all tax items to be allocated in accordance with the percentage interests of the residual interest holders. The obvious model is the "one class of stock" rules in subchapter S.

There is difficulty, however, in defining exactly what a "one class of stock" rule means in the context of a partnership, LLC, or other unincorporated venture. Corporate stock generally provides the holder with both a profits and capital interest in the firm. Moreover, each share of stock in the same class ordinarily has identical rights with respect to distributions and liquidation proceeds. Finally, changes in the percentage interest in a given class of shares arise in connection with a contribution, redemption, or purchase and sale transaction, all of which may be taxable events and have, in any event, only prospective effect.<sup>176</sup>

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176. The permissible allocation of all tax items in a pro rata manner to each day of the taxable year of an S corporation creates the possibility of a change in interest having some retroactive effect. See IRC § 1377(a)(1).

In contrast, it is possible to create partnership or LLC interests which are “profits only” interests.<sup>177</sup> Ownership interests may not entail any set formula for distribution and liquidation rights. And changes in percentage interests may be made by private agreement, ordinarily without tax consequences and potentially with retroactive effect.

The check-the-box regulations will require the Treasury to specify what an unincorporated venture will need to do to satisfy the “one class of stock” rule in subchapter S. Under those regulations, an unincorporated firm may elect to be taxed as a corporation and, if the S eligibility requirements are satisfied, elect to be taxed as an S corporation.<sup>178</sup> (An unincorporated firm might wish to do so, for example, to facilitate a future tax-free reorganization with a subchapter C corporation.) To date, however, no guidance has been issued.<sup>179</sup>

In the absence of such guidance, the SPBF proposals dictate restrictions on the terms of the ownership interests of an unincorporated firm to follow closely the normal consequences in the corporate context. Thus, an SPBF may have only a single class of residual ownership interests and each such interest must provide the holder with identical rights with respect to the income, loss, distributions, and liquidation proceeds of the SPBF. All tax items (other than income allocated to preferred interest holders, described shortly) must be allocated in a “straight-up” manner in accordance with the per-day, percentage share of the owner in the residual class of interests. A change in interest may occur only upon a contribution, a partial or complete redemption of an owner’s interest, or the purchase and sale of interests by the owners. Finally, changes in interests may have prospective effect only.

Obviously, these limitations may be too restrictive, and may unnecessarily undermine the appeal of the SPBF option. For example, they might seem to preclude the common “money-and-brains” venture where one or more persons supply all of the capital needs of the firm and other persons provide services in exchange for a profits only interest. In fact, it may be possible to accommodate that arrangement and others in the SPBF system (as

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177. The term “profits only” interest merely signifies the absence of a capital interest in the firm. A “profits only” partner may or may not share in the losses of the firm.

178. See Regs. § 301.7701-3(a); Staff of the Joint Comm. on Tax’n, 105th Cong., Review of Selected Entity Classification and Partnership Tax Issues, 24 n.48 (Comm. Print 1997).

179. Priv. Ltr. Rul. 96-36-007 (May 30, 1996) involved the transfer of all of the assets and liabilities of an S corporation to an LLC classified as a corporation for tax purposes under the prior version of the classification regulations. The Service held that if the transaction qualifies as an “F” reorganization and if the LLC meets the requirements of an S corporation, the transaction would not terminate the transferor’s S election and such election would apply to the surviving entity. The ruling did not specify what the LLC would need to do in order to meet the requirements of an S corporation.



they are accommodated in subchapter S) through the use of salary payments, deferred compensation,<sup>180</sup> options,<sup>181</sup> restricted stock,<sup>182</sup> straight debt,<sup>183</sup> and preferred interests (described below). To provide flexibility beyond these forms would seem to result in the undesirable introduction of complexity into the SPBF system, such as a required maintenance of capital accounts.<sup>184</sup>

b. *Preferred Interests.*—The proposal, however, does allow an SPBF to issue limited classes of preferred interests. In effect, this permits a narrow form of special allocation—a preferred allocation of income to one or more classes of owners. Permissible preferred interests provide income preferences only which are fixed and limited to the earnings of the firm, are not convertible into any other interest of the firm, and do not provide for redemption or liquidation rights in excess of the issue price of the interest.

A preferred interest generally lies on the border between an equity interest and debt. For the most part, in an SPBF, the need to distinguish between equity and debt is not great, particularly when the holder of the interest is viewed as an owner of the enterprise in any event. The preferred interest simply allocates part of the income of the firm to one class of owner, thereby allocating it away from other owners. Ultimately, all the income of the firm is taken into account by its owners.

Whether a preferred interest of an SPBF is thought of as a form of debt or equity makes a difference, though. Strictly, holders of equity interests in a business taxable as a conduit should be allocated income whose character is determined at the entity level. However, if that rule were applied to preferred interests, clever planning could convert the preferred interest into a special item allocation. One preferred class could receive the first \$100,000 of capital gain income that happened to arise in that year, another class could receive the first \$100,000 of foreign income arising in a different year, etc.

Therefore, the proposal allows for a preferred interest which will receive only an allocation of ordinary income, with the firm being entitled to the equivalent of an ordinary deduction. Thus, the allocation of income

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180. See Regs. § 1.1361-1(b)(4).

181. See Regs. § 1.1361-1(l)(4)(iii)(B)(2).

182. See Regs. § 1.1361-1(b)(3).

183. See IRC § 1361(c)(5).

184. It is unclear whether capital accounts might, in theory, already be required for subchapter S corporations. The regulations provide that the one class of stock requirement is met so long as the governing provisions provide for identical distribution and liquidation rights, even though the actual timing of the distributions is not uniform. See Regs. § 1.1361-1(l)(2)(i), -1(l)(2)(v), ex. 2. If the timing of distributions varies, some account may be necessary to keep track of the rights of the shareholders during the interim.

pursuant to a preferred interest would be analogous to the payment of interest by the firm to the holder.

The proposal contemplates more than one class of preferred interests in an SPBF. The different classes are to be distinguished solely on the basis of their priority: the most senior class would have allocated to it a certain amount of the firm's income; when that amount has been allocated, the next senior class would have allocated to it a certain additional amount of the firm's income; and so forth down to the residual class of interests which would have the most junior claim to income. The classes are not to be distinguished based on the nature of the income earned. Thus, there cannot be one class that receives the first \$10,000 of foreign income, another class that receives the first \$10,000 of capital gain income, etc.

Income allocations to preferred interest holders are permissible only when the firm has earned the money needed to make the allocation, that is, under circumstances analogous to situations in which a dividend could be paid by a corporation. Because an SPBF has no equivalent of accumulated earnings and profits (all income from prior years is effectively "distributed" for tax purposes through the allocation process), income is allocable only if the firm has net income for the year in that amount. At the same time, if the firm has enough income to support the preference, the income is allocable even though there is no distribution. If no distribution is ever made of previously allocated amounts, the firm will have ordinary debt forgiveness income. Such income should cancel out the effect to the residual owners of the prior income allocation.

Allocations must be made based on the period the preferred interest is held and the extent of the holder's interest. For example, suppose on December 1, a taxpayer purchases a preferred interest in the first \$12,000 of a calendar-year firm's annual income and holds that interest until the end of the calendar year. The taxpayer may not be allocated more than \$1,000 of the firm's income for the year.

Although allowing preferred interests increases the flexibility of owners of SPBFs, it should not override the general prohibition against special allocations. Thus, suppose the taxpayer in the above example attempts to purchase on December 31 a preferred interest in the first \$3,650,000 of the firm's income. The allocation rule described above would allow \$10,000 of the firm's income to be allocated to the taxpayer. However, the interest would have to be issued for value. The value of an interest worth \$3,650,000 annually should be quite high. Unless the preferred interest was issued for its true value, general tax doctrines relating to sham transactions should be applicable to prevent the allocation of \$10,000 to the taxpayer.

c. *Losses*.—As described above, losses of an SPBF may only be allocated to the residual interest owners of the firm. Consistent with

sections 704(d) and 1366(d), the passthrough of SPBF losses or deductions is limited to such owner's basis in residual or preferred interests in the firm as of the end of the year in which the loss is incurred. Any losses passed through to an owner would reduce his or her outside basis in the same order as in current subchapter S—first to the owner's basis in residual interests, if any, and then to the basis of any preferred interests.<sup>185</sup> Any losses disallowed by reason of the basis limitation shall be treated as incurred by the firm in the succeeding taxable year with respect to the owner involved.<sup>186</sup>

d. *SPBF Liabilities.*—One major difference between the rules of subchapter K and the rules of subchapter S is that partners but not S corporation shareholders include both recourse and nonrecourse debts of the entity in their outside bases.<sup>187</sup>

Inclusion of debt in outside basis provides partners with several potential tax benefits. Because distributions from both a partnership and an S corporation are taxable to the extent money distributed exceeds outside basis, the partnership rule reduces the likelihood of a partner being taxed in such a transaction.<sup>188</sup> For a similar reason, contributions of property encumbered by liabilities in excess of the transferor's basis in the property are more likely to be taxable transactions in the world of subchapter S than subchapter K.<sup>189</sup>

But the major consequence of including debt in basis is that it increases the likelihood that the owner can deduct losses incurred by the entity. This outcome results from the rule for both S corporations and partnerships which generally limits an owner's deduction of losses to the amount of his or her outside basis.<sup>190</sup> As just described, such a rule is included in the SPBF system.

The decision of whether to include entity debt in the basis of owners of an SPBF is a difficult one. As a theoretical matter, some might argue that the paradigmatic case justifying inclusion of debt in outside basis is the general partnership whose partners are jointly and severally liable for all of the firm's debts. Under those circumstances, it makes sense to provide the partners with tax basis for their share of the firm's liabilities. Adherents to this view might point to the absence of a comparable provision in subchapter

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185. Cf. IRC §§ 1366(d)(1), 1367(b)(2).

186. Cf. IRC § 1366(d)(2).

187. See IRC § 752.

188. See IRC §§ 731(a)(1), 1368(b).

189. See IRC § 357(c). Partners are generally taxed only if the *net amount of liability relief* (after taking into account the partner's share of the resulting partnership liability) exceeds the partner's basis in the property transferred. See Regs. § 1.752-1(f); IRC § 731(a)(1).

190. See IRC §§ 704(d), 1366(d).

S, perhaps because of the limited liability protection offered the shareholders of an S corporation. Thus, it could be argued that entity debt should be included in the outside basis of an owner only in circumstances where the owner is personally liable for repayment of the debt.

Such a rule would draw a sharp distinction between taxpayers based on their choice of organizational form—proprietors, co-owners, and general partners, for example, would obtain basis for their business debts, but owners of other firms, such as limited partnerships, limited liability companies or corporations, would not. It might discourage the use of the latter forms of business organization. It would also be at cross purposes with the current law entity classification rules which generally disregard limited liability and other organizational characteristics for income tax purposes.

Moreover, current law allows taxpayers to receive tax basis for indebtedness even though the taxpayer is protected from personal liability on the debt because it is nonrecourse.<sup>191</sup> That tax principle would seem to reduce the force of a distinction based on the presence or absence of limited liability protection for the owners of the firm.

In addition, as a practical matter, many smaller businesses, regardless of their organizational form, are able to borrow money only if their owners are held accountable for the borrowing, for example as guarantors. If entity debt were included in an owner's outside basis only if the owner were liable for the debt, would an owner guarantee affect basis?<sup>192</sup> If not, owners may simply be forced to structure their borrowing in certain ways—for example, borrowing directly and then contributing the proceeds to the firm—rather than using other, more natural and more easily attainable ways. As is true in subchapter S, there would be a premium on proper tax planning. Other complicated rules may also be needed to relieve the absence of rules like section 752, such as the provisions in subchapter S enabling losses to be deducted up to debt basis.<sup>193</sup>

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191. See *Crane v. Commissioner*, 331 U.S. 1 (1947).

192. In subchapter S, the answer generally is "no." See, e.g., *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988), aff'd, 875 F.2d 420 (4th Cir. 1989), cert. denied, 493 U.S. 958 (1989); *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990). In both subchapter K and in determining whether the guarantor is "at risk" with respect to the liability, the answer may be "yes," generally depending upon the nature of the primary obligor's obligation and the reimbursement rights of the guarantor. See Regs. § 1.752-2(b)(3)(i), (5), and (6); Prop. Regs. § 1.465-6(d) (guarantee does not increase at risk amount); *Brand v. Commissioner*, 81 T.C. 821 (1983) (guarantee does not increase at risk amount because of guarantor's right of indemnification against the partnership); *Peters v. Commissioner*, 89 T.C. 423 (1987) (same); *Abramson v. Commissioner*, 86 T.C. 360 (1986) (guarantee increased at risk amount because there was no primary obligor and no right of reimbursement from anyone).

193. See IRC § 1366(d)(1)(B).

Finally, the basic case against inclusion of entity debt in outside basis is not limited to the taxation of an SPBF; the argument applies with equal force to non-SPBF private business firms. In other words, the argument would question the presence of section 752 in the default version of conduit taxation, i.e., subchapter K, and not just in the SPBF system. This follows from the fact that the SPBF classification line is not based on the limited liability protection offered to the owners of the firm.

Indeed, for several reasons, a much stronger case could be made to exclude section 752 from the default conduit version than to exclude it from the SPBF system. For one thing, inclusion of debt in basis increases the amount of losses of the firm currently available to owners. It therefore places greater pressure on the proper allocation of those losses. But unlike the default version of conduit taxation, which may be vulnerable to potential misallocations of tax items, the SPBF system mandates a straightforward allocation scheme designed to preclude manipulative possibilities. In particular, all losses of an SPBF are allocable only to residual interest holders in accordance with their percentage interest in that class of ownership. Hence, the inclusion of debt in basis is much less likely to result in an abusive outcome in the SPBF system than in the default system.

Second, the allocation of debt of the firm among the owners is considerably more difficult for the default conduit system than in the SPBF system. In subchapter K, for example, the regulations under section 752 generally attempt to allocate partnership debt among the partners in accordance with the manner in which they share the economic risk of loss relating to the liability.<sup>194</sup> Yet to determine that share, the regulations require one to fantasize a completely improbable scenario—a constructive liquidation of the partnership under the worst possible circumstances.<sup>195</sup> This process is a complicated one and leaves serious doubt whether the allocation of liabilities authorized by the regulations is appropriate.<sup>196</sup> Further, the basic economic risk of loss analysis does not apply in determining the allocation of *nonrecourse* liabilities of a firm, or of *any* liabilities of a firm, all of whose owners are provided with limited liability protection.<sup>197</sup> These problems are virtually eliminated in an SPBF where all

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194. See Regs. § 1.752-2(a).

195. See Regs. § 1.752-2(b)(1).

196. See Berger, *supra* note 63, at 123 (“At best, the § 752 technique for measuring a partner’s ‘economic risk of loss’ offers a crude surrogate for quantifying a partner’s actual risk, which is indeterminate; inevitably, the § 752 calculation exaggerates the partner’s exposure.”).

197. See *id.* at 137 (“[A]llocations rooted in nonrecourse debt cannot have economic reality, or any reality, whatsoever, except in the ingenious, magical and mechanical world of the § 704(b) regulations.”).

liabilities, recourse and nonrecourse, as well as the losses of the firm may be allocated straight up to the owners in accordance with their residual ownership interests.

Finally, the “at risk” (section 465) and passive activity loss (section 469) rules provide another layer of protection against the improper deduction of losses by taxpayers, and that protection is particularly effective in the SPBF context. This is because the principal taxpayers exempt from those rules are nonclosely-held C corporations.<sup>198</sup> But as previously described, a public C corporation may not be an owner of an SPBF. Thus, in contrast to the owners of firms taxed under the default conduit system, all owners of an SPBF would be subject to the at risk and passive activity loss restrictions.

Indeed, the broad applicability of the at risk rules in an SPBF setting seems to make unnecessary a rule restricting the passthrough of SPBF debt only to owners personally liable for repayment of the debt. Such a rule in fact was enacted in 1976<sup>199</sup> but was repealed just two years later as “redundant” in view of an expansion of the at risk rules.<sup>200</sup> Since that time, the at risk rules have been expanded even more<sup>201</sup> and, as noted, they would provide virtually full coverage to participants in an SPBF venture. Thus, limited partners, members of an LLC, and other owners with limited liability protection are generally not treated as being “at risk” with respect to their firm’s debts, recourse or nonrecourse.<sup>202</sup> They therefore may be unable to deduct their share of losses attributable to those debts even if their outside bases were sufficient to permit the deduction.<sup>203</sup>

To be sure, certain nonrecourse real estate financing falls outside of the at risk rules.<sup>204</sup> Thus, one might argue that those rules provide an inadequate shield against the claiming of uneconomic passthrough losses. Whatever the merits of the real estate exception, however, one cannot expect the issue to disappear in a debate regarding whether to include a firm’s

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198. See IRC §§ 465(a)(1)(B), 469(a)(2)(B). A C corporation is subject to the at risk rules if five or fewer individuals own more than 50% of the corporation. See IRC § 542(a)(2).

199. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(e), 90 Stat. 1520, 1548 (1976) (amending § 704(d)).

200. See Revenue Act of 1978, Pub. L. No. 95-600, § 201(b)(1), 92 Stat. 2763, 2816 (1978); Staff of the Joint Comm. on Tax’n, 96th Cong., 1st Sess., General Explanation of the Revenue Act of 1978 130 (Comm. Print 1979).

201. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 503(a), 100 Stat. 2085, 2243 (1986) (repealing blanket exclusion from at risk rules of real property activities).

202. See S. Rep. No. 938, 94th Cong., 2d Sess. 49 n.3 (1976), reprinted in 1976 U.S.C.A.N. 3439, 3485; McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* 10-171 (3d ed. 1997).

203. See IRC § 465(a)(1). See Eustice, *supra* note 175, at 399 (would let at risk rules rather than outside basis dictate significance of owners’ personal liability for entity debt).

204. See IRC § 465(b)(6).

nonrecourse financing in an owner's outside basis. Presumably, the same interests which have successfully exempted certain real estate financing from the at risk rules would push for inclusion of the same financing in outside basis. Thus, the basic issue concerns the merit of the real estate exception; it is unreasonable to assume that the issue will somehow be circumvented by shifting the controversy to section 752. And for that reason, there is no basis to decide the section 752 question because of concern about the real estate exception.

In conclusion, including entity debt in the outside basis of SPBF owners would help to eliminate tax distinctions based on organizational form and characteristics and permit businesses to finance their activities as they wish, without regard to tax considerations and tax planning. Further, the restrictive allocation rules of an SPBF and the broad applicability of the at risk and passive activity loss rules to SPBF owners would protect against the potential misuse of resulting passthrough losses. Finally, as an administrative matter, the allocation of the debt to SPBF owners could be done in a straightforward manner based on the owners' shares of the residual interests of the firm. Although certain of these reasons are inapplicable to the default version of conduit taxation—and, therefore, additional thought must be given to whether section 752 principles should be available in that world—these reasons seem more than adequate to justify inclusion of those principles in the SPBF system.<sup>205</sup>

### 3. Contributions and Distributions

a. *Contributions—Present Law.*—Almost any contribution to a partnership in exchange for a partnership interest is tax-free. The major exception is the contribution of services in exchange for an interest in the capital of the partnership.<sup>206</sup> In general, the IRS treats the receipt for services of a mere partnership profits interest as being tax-free.<sup>207</sup>

In contrast, contributions to an S corporation are governed by the same rules that apply to all corporations.<sup>208</sup> Accordingly, a transfer of property to an S corporation in exchange for its stock is tax-free only if the transferor, either alone or with a group of transferors, owns at least 80% control of the corporation following the transfer.<sup>209</sup> Furthermore, any stock

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205. Inclusion of § 752 principles in the SPBF system, but not the default system, would have the side benefit of increasing the appeal of the simplified system to taxpayers.

206. See *United States v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

207. Rev. Proc. 93-27, 1993-2 C.B. 343.

208. See IRC § 1371(a)(1).

209. See IRC § 351.

of an S corporation received in exchange for services is taxable to the recipient.<sup>210</sup> Although this rule is different from the partnership rule, it results from the fact that an S corporation has only one class of stock. Thus, stock in an S corporation must inevitably carry with it an interest in the capital of the corporation. As noted, when services are contributed in exchange for partnership capital, the transaction is taxable.

The tax authorities early on accepted the proposition that a contribution of property to a partnership in exchange for a partnership interest is not a taxable event.<sup>211</sup> The 1920 Solicitor's Opinion which first makes this point quotes *United States v. Coulby*,<sup>212</sup> for the proposition that "[u]nlike a corporation, a partnership has no legal existence aside from the members who compose it." The Solicitor's Opinion goes on to say:

It thus appears, both from the decision of the Federal court and from the ruling of this department, that, for income tax purposes, the common law doctrine of the nature of a partnership must be adhered to, and that the more modern doctrine, prevailing in some States, which recognizes a partnership for many purposes as an entity not greatly differing from the corporation, must be ignored.

A 1932 General Counsel Memorandum emphasizes that this rule is a function of nonrealization, not nonrecognition, since the statute did not provide any special rule in this area.<sup>213</sup> The General Counsel Memorandum extracts from this analysis the rule now embodied in section 704(c). That is, if a contribution of appreciated property to a partnership is not considered a realization event yet the contributing partner is given economic credit for the full value of the property, then it follows that the gain inherent at the time of the contribution must be allocated to such partner.<sup>214</sup>

A partner recognizes gain, and a shareholder of an S corporation recognizes gain or loss, upon a transfer of property to a firm qualifying as an "investment company."<sup>215</sup> The 1997 Act broadened the definition of investment company to stem the reappearance of "swap funds," i.e., firms

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210. See IRC § 351(d)(1).

211. Sol. Op. 42, 3 C.B. 61 (1920).

212. 251 F. 982 (6th Cir. 1918).

213. Gen. Couns. Mem. 10,092, XI-1 C.B. 114 (1932), revoked on another issue, Gen. Couns. Mem. 26,379, 1950-1 C.B. 58.

214. The courts did not accept this position of the Commissioner, and the result ultimately had to be achieved by statute. See *Eaton v. Commissioner*, 37 B.T.A. 715 (1938); see also *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934) and *Helvering v. Archbald*, 70 F.2d 720 (2d Cir. 1934).

215. See IRC §§ 351(e)(1), 721(b).



permitting investors to obtain tax-free diversification of their investment assets.<sup>216</sup>

b. *Distributions—Present Law.*—In contrast to the roughly comparable provisions for contributions, the rules dictating the tax consequences of distributions from a partnership or S corporation are much different. A partnership is never taxed on a distribution to a partner as such.<sup>217</sup> In some cases, as discussed subsequently, complicated rules may cause the partnership distribution to be recharacterized as something else, but there is no tax absent such recharacterization. In contrast, distributions from an S corporation are governed by the anti-*General Utilities* rules of sections 311 and 336, which cause gain inherent in the distributed property, and loss inherent in property distributed in liquidation, to be recognized by the corporation (and passed through to the shareholders) as if the property had been sold.

The taxation of the distributee is also much different. The partnership rules minimize the amount of gain or loss that must be recognized in a distribution. In doing so, they rely on a partner's outside basis as the final determinant of how much basis will be available to the partner following the distribution and how much gain or loss must be recognized in the transaction. Indeed, it is generally only where money distributed exceeds outside basis that gain must be recognized, because the basis of money cannot be reduced below its face value.<sup>218</sup> And it is generally only where a partner's outside basis would otherwise be lost forever, as in the case of a liquidating distribution of money less than the distributee's outside basis, that loss may be recognized.<sup>219</sup> The nonrecognition objective and the policy decision to rely upon outside basis result in certain complications where outside basis and the aggregate inside bases of the properties distributed are different from one another.<sup>220</sup>

The S corporation rules are different. In an ordinary distribution, a distributee must recognize gain to the extent the money and value of property distributed exceed the distributee's stock basis.<sup>221</sup> A similar rule applies in

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216. See Staff of the Joint Comm. on Tax'n, 105th Cong., 1st Sess., *General Explanation of Tax Legislation Enacted in 1997*, 183 (Comm. Print 1997).

217. See IRC § 731(b). This discussion assumes that a liquidating distribution is taxed as a distribution under § 736(b)(1) rather than as a distributive share or guaranteed payment under § 736(a).

218. See IRC § 731(a)(1). Section 731(c) is an exception to this rule discussed later.

219. See IRC § 731(a)(2)(A). Loss is also recognized to prevent the distributee's excess outside basis from being allocated to ordinary income items distributed. See IRC § 731(a)(2)(B).

220. See IRC § 732.

221. See IRC § 1368(b).

a liquidating distribution except that the shareholder may recognize loss as well.<sup>222</sup> Finally, gain or loss is recognized in a partial liquidation of a shareholder's interest except that the shareholder's outside basis must be allocated to the shares redeemed.<sup>223</sup> Thus, in combination with the tax treatment of the corporation, all gains and most losses are recognized in a distribution by an S corporation. The shareholders therefore receive a fresh-start fair market value basis in any property distributed.<sup>224</sup>

c. *Additional Partnership Rules to Prevent Income Shifting, Income Character Changes, and Timing Distortions.*—As just described, the partnership tax rules are more liberal than the S corporation rules in permitting property to be transferred into and out of the firm without the recognition of gain or loss. The generally unimpeded nature of partnership transfers has necessitated basis preservation and allocation rules as well as a series of additional rules designed to prevent income shifting, income character changes, and timing distortions. As a conceptual matter, because property more frequently changes ownership in the partnership world without the recognition of gain or loss, there is greater pressure to develop and maintain links between the property transferred and the original owner to make sure the eventual recognition of income or loss is of the right amount, to the right person, of the right character, and at the right time. The following is just a sample of the provisions that have been developed to achieve those ends:

i. *Section 704(c)(1)(A).*—We have already seen the IRS's early recognition of the need for a rule to prevent the shifting of gains or losses from the contributor of built-in gain or loss property to some other partner. As an important exception to the rule that all allocations must have economic effect, section 704(c)(1)(A) requires a special allocation of such gains or losses back to the contributor.

A common problem occurs under section 704(c)(1)(A) where the subsequent tax items arising from the partnership's ownership of the contributed property are less than the amount of built-in gain or loss at the time of the contribution.<sup>225</sup> For example, land contributed with built-in gain

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222. See IRC §§ 331(a), 302(a).

223. See IRC § 302(a). The term "partial liquidation" refers to a transaction in which a distribution redeems some, but not all, of the distributee's interest in the firm. It should not be confused with the use of the term in §§ 302(b)(4) and (e), dealing with liquidating events occurring at the entity level.

224. See IRC §§ 301(d), 334(a).

225. One commentator states that ceiling-limited situations constitute a "pervasive obstacle to satisfying the objectives of § 704(c)" and speculates that they arise in over one-half of all possible cases. See John P. Steines, Jr., *Partnership Allocations of Built-in Gain or Loss*, 45 Tax L. Rev. 615, 647 (1990).

of \$7,000 might be subsequently sold by the partnership for a \$6,000 gain. Economically, this transaction could be broken into a \$7,000 gain to be allocated to the contributor plus a \$1,000 loss to be shared by all of the partners. The so-called "ceiling rule," however, generally does not permit that outcome.<sup>226</sup> Apparently, the concern of the Treasury has been the extension of partnership "flexibility" into a world of make-believe, i.e., a world in which a \$7,000 gain and a \$1,000 loss are being allocated to the partners when, in fact, neither tax result actually occurred. This concern is warranted because the propriety of both the "\$7,000 gain" and the "\$1,000 loss" depends upon the accurate valuation of the property initially, a questionable assumption in certain cases. Thus, the ceiling rule permits a special allocation of at most \$6,000 in this example, the amount of tax gain actually recognized by the partnership from the sale of the property.

The current regulations offer three ways of dealing with the problem of ceiling-limited transactions. One possibility is to ignore the problem, which permits a certain amount of income shifting to occur.<sup>227</sup> To protect the fisc, however, and to further complicate matters, taxpayers may not choose to ignore the problem if they entered into the ceiling-limited transaction "with a view" towards gaining that tax advantage.<sup>228</sup> Another possibility is to make so-called "curative allocations" of tax items unrelated to the contributed property in order to make up for the shortfall.<sup>229</sup> Curative allocations are allocations of *tax items only* and thus also violate the economic effect test. In a general effort to conform the cure to the problem, various restrictions are imposed on the amount, character, and timing of the tax item subject to the curative allocation<sup>230</sup> and curative allocations are impermissible in certain cases where the taxpayer has the wrong subjective purpose.<sup>231</sup> A final option is to make "remedial allocations," which are similar to curative allocations except that they are entirely make-believe.<sup>232</sup> Rather than repealing the ceiling rule altogether, the IRS has prescribed remedial allocations as the one permissible method for creating fictitious allocations in order to avoid the undesirable effects of the ceiling rule.<sup>233</sup>

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226. See Regs. § 1.704-3(b)(1).

227. See Regs. § 1.704-3(a)(1), -3(b)(1).

228. Regs. § 1.704-3(a)(10), -3(b)(2), ex. (2)(ii).

229. Regs. § 1.704-3(c)(1).

230. See Regs. § 1.704-3(c)(3).

231. See Regs. § 1.704-3(c)(4), ex. (3). For the view that these subjective overrides should have only a limited reach, see Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 Fla. Tax Rev. 93, 115 (1996).

232. See Regs. § 1.704-3(d)(1) (authorizing the *creation* of remedial items by the partnership).

233. See Regs. § 1.704-3(d)(5)(i).

ii. *Reverse Section 704(c) Allocations.*—The need for a reverse section 704(c) allocation arises whenever there is some change in the ownership of a partnership and one or more partnership assets contains a built-in gain or loss at that time. Thus, if new partner C joins existing partners A and B at a time when partnership AB has certain assets with built-in gains, those gains must be specially allocated to A and B and away from C in order to prevent income shifting among them. Of course, certain of those gains might already be subject to an existing, “regular” section 704(c) special allocation if the asset was contributed by A or B with a built-in gain or loss, so matters can get complicated fairly quickly.<sup>234</sup> The regulations deal with reverse section 704(c) allocations in the same manner as regular section 704(c) allocations.<sup>235</sup> Under the regulations, however, just to make sure everyone stays alert, partnerships are *not* required to use the same allocation method for both regular and reverse section 704(c) adjustments even if such adjustments relate to the same property at the same time.<sup>236</sup>

iii. *Section 704(c)(1)(B).*—Assuming that one can keep track of all of the required and prohibited special allocations, they would nevertheless not be wholly effective at preventing the potential income shifting from built-in gains and losses. One reason is that special allocations under section 704(c)(1)(A) only apply to tax items *of the partnership*; therefore, if property subject to a special allocation somehow escapes the partnership in a nonrecognition transaction, such as through a distribution to a partner other than the contributing partner, then the mandated special allocation is rendered impotent. Section 704(c)(1)(B) generally deals with that problem by providing that a distribution of built-in gain or loss property within seven years of its contribution to the partnership triggers gain or loss to the contributing partner equal to the amount that would have been specially allocated to such partner had the partnership sold the property.<sup>237</sup>

iv. *Section 737.*—Another reason a mandated special allocation might prove to be ineffective is if the partner to whom the built-in amount is to be allocated ceases to be a partner prior to such allocation. Special allocations only serve to shift tax items *among partners* of the

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234. Regular special allocations of the gains and other tax items from the property may also be permitted or prohibited depending upon compliance with the substantial economic effect test and one or more subjective purpose standards.

235. See Regs. § 1.704-1(b)(4)(i) and -1(b)(5), exs. (14)(i) - (iv), (18)(ii) - (xiii).

236. See Regs. § 1.704-3(a)(6)(i). Nor are partnerships required to use the same allocation method in coping with a series of reverse § 704(c) adjustments. See id.

237. Query whether the rule should also apply to built-in gains or losses arising not just from a contribution but also in a reverse § 704(c) situation.

partnership; thus, to do the job right, one must monitor potential tax-free disappearances of partners by means of, for example, a liquidation of the partnership interest. Indeed, in certain cases, tax advantage may be gained even if the contributing partner does *not* completely disappear from the scene, but is only the recipient of a tax-free distribution. Congress took its first step down this road by enacting section 737 which generally treats as a gain recognition event a distribution of property to a partner who contributed built-in gain property to the partnership within the previous seven years.

v. *Section 707(a)(2)(B)*.—In addition to income-shifting concerns, the liberal manner in which property can enter and leave a partnership without the recognition of gain or loss raises the question whether the contribution and distribution are in reality a taxable sale. Section 707(a)(2)(B) attempts to make this nebulous determination based upon whether the two transfers “are properly characterized as a sale or exchange of property.” The regulations interpret this unhelpful statutory standard by creating a two-year rule of thumb as well as a series of additional rules. There is a rebuttable presumption that transfers occurring within two years of one another constitute a sale or exchange and that those outside that time frame are not.<sup>238</sup>

vi. *Section 731(c)*.—A related concern is addressed by section 731(c), enacted in late 1994. Recall that cash distributions from a partnership are generally taxable to the extent the cash exceeds the distributee’s basis in the partnership, but property distributions are generally tax-free. In a remarkably convoluted rule, section 731(c) treats a portion of “marketable securities” as cash for purposes of the distribution rule. Thus, a distribution of marketable securities may result in gain recognition to the distributee. According to the legislative history, the transaction is the “economic equivalent of a sale of a partner’s share of the partnership’s [other] assets” for an increased share of the partnership’s marketable securities.<sup>239</sup> This characterization of the transaction bears resemblance to section 751(b), described next.

vii. *Sections 724, 735, and 751(b)*.—Liberal nonrecognition rules on property transfers breed a greater need for income character tracing rules to prevent a character shift when the tax consequences from the property are ultimately recognized. Section 724 traces the character

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238. See Regs. § 1.707-3(c)(1), -3(d).

239. H.R. Rep. No. 826, 103d Cong., 2d Sess. 187 (1994), reprinted in 1994 U.S.C.C.A.N. 3959.

of contributed property and section 735 serves the same purpose for distributed property. In addition, section 751(b) recharacterizes a distribution as a taxable exchange by the partners if, as a result of the distribution, there is a change in the partners' share of the ordinary income items of the partnership. Because its operative impact is to create an exchange among the partners, section 751(b) also has an important effect on the *timing* of the recognition event. In a partnership distribution, the provision can, with great surprise, result in the taxation of a partner who is not a distributee on gains inherent in property which is not distributed.<sup>240</sup> As noted, one partnership tax expert has asserted that there is a mere 2-1/2% compliance rate with section 751(b)<sup>241</sup> and another has characterized it as "the Achilles heel of subchapter K."<sup>242</sup>

viii. *Subjective Purpose*.—Finally, the general "anti-abuse" regulation in the partnership area overlays all of the foregoing rules and may operate to reverse the tax consequences of any one of them.<sup>243</sup> As previously noted, the rule may even override the taxpayer's compliance with some other, more specific, anti-abuse rule, such as the disguised sale provision in section 707.<sup>244</sup>

d. *Analysis of Current Law*.—As we have seen, the partnership tax rules are more liberal than the S corporation rules in providing nonrecognition of gains and losses upon property transfers to and from the firm and, as a result, a veritable array of highly complex, anti-abuse rules, some mechanical in application and some based on subjective standards, have also developed in the partnership area.<sup>245</sup> Although certain of the same concerns in the partnership area are present for taxpayers in a subchapter S setting, the S rules are remarkably free of the same complications.<sup>246</sup> In

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240. See, e.g., Regs. § 1.751-1(g), ex. (3).

241. Hearings, *supra* note 63 (statement of Joel Rabinovitz).

242. See Eustice, *supra* note 175, at 383.

243. See Regs. § 1.701-2(b).

244. See *supra* note 70.

245. For criticism of these anti-abuse protections, see Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 *Tax L. Rev.* 173, 181-98 (1991). See also Terence Floyd Cuff, *The Section 704(c)(1)(B) Proposed Regulations*, 73 *Taxes* 283, 284 (1995) ("The intricate web of anti-abuse rules [affecting contributions and distributions of partnership property] challenge the most talented partnership tax practitioner . . . . A partnership may undertake a seemingly innocent transaction and discover itself tangled in a web of anti-abuse provisions. These provisions complicate even routine partnership transactions.").

246. Subchapter S is not, however, completely free of such complications. For example, S corporations are subject to the collapsible corporation rules, which are similar in

part, this phenomenon is attributable to the more restrictive nature of subchapter S; for example, a section 704(c)(1)(A)-type solution cannot easily be prescribed where special allocations are not permitted. In part, it may be a consequence of a policy judgment to maintain a modicum of simplicity for the S rules. But in important part, it results from the fact that fewer transfers to and from an S corporation are tax-free.

Moreover, despite this complicated web of rules, partnership distributions still provide ample opportunity for manipulation by taxpayers. Manipulation may result from a misallocation or mistiming of income or other partnership tax items as a result of the distribution, or a conversion of ordinary income into capital gains.<sup>247</sup> To illustrate one conversion possibility, consider the following simplified example:<sup>248</sup>

*Example 1.* A and B form AB, an equal partnership. A contributes unimproved land worth \$10,000 with a basis of \$10,000, and \$20,000 cash. B contributes a depreciable asset worth \$20,000 and with a basis of \$20,000, and \$10,000 cash. The depreciable asset increases in value to \$30,000. AB then liquidates, with A receiving the depreciable asset and \$5,000, and B receiving the land and \$25,000.

In the liquidation, neither the partnership nor either of the partners recognizes any gain or loss. A preserves his or her \$30,000 outside basis by getting \$5,000 cash and taking the depreciable asset with a \$25,000 basis. B does likewise by getting \$25,000 cash and taking the land with a \$5,000 basis. Although the total amount of potential gain in the partnership before the liquidation (\$10,000) is still preserved in the partners' hands afterwards (\$5,000 of lurking gain for each partner) the ability to shift basis around from one asset to another provides potential tax advantages. In effect, the value of the dollars of basis available to the parties has been increased as a result of the liquidation, since the basis of the depreciable asset will be used to reduce ordinary income currently through depreciation deductions while the basis of the land, which won't be used until the land is sold, may ultimately affect only the amount of a capital gain recognized in the future.<sup>249</sup> In theory, this

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objective and complexity to § 751. In addition, to the extent the partnership anti-abuse rule is simply articulating a common-law "substance over form" standard generally applicable to all of tax law, the subchapter S provisions are of course subject to that standard.

247. For some examples, see Andrews, *supra* note 67; ALI 1984 Subchapter K Proposals, *supra* note 60, at 195-200; 1997 JCT Partnership Tax Study, *supra* note 67, at 27-38; Regs. § 1.701-2(d), exs. (8)-(11).

248. This example disregards the possible application of the general anti-abuse rule in the partnership area.

249. If the depreciable asset is a § 1231 asset, then increasing its basis may also provide the taxpayer with an ordinary loss upon sale of the asset. See IRC § 1231(a)(2).

rule is symmetric; if the land and not the depreciable asset had increased in value, basis would have been shifted to the land (and away from the depreciable asset) on liquidation. However, if that had been the case, the partnership need not have liquidated.

The manipulation possibilities illustrated by example 1 are even greater as a result of the 1997 tax act. This is because the partnership tax law, in trying to preserve character due to the nonrecognition consequences of most partnership distributions, merely segregates certain ordinary income assets from other assets; it unjustifiably treats all of those other assets alike.<sup>250</sup> As shown by example 1, this procedure is obviously incorrect to the extent it lumps depreciable and nondepreciable property together. But it is even more incorrect under post-1997 Act law because of the additional new categories of assets created by that Act. Depending upon the tax bracket of the taxpayer, the nature of the asset involved, and its holding period, gains on the sale of assets may be taxed at a series of possible tax rates ranging from 8% to ordinary income rates.<sup>251</sup> In addition, the taxation of gains from real estate will vary, depending upon whether the gain is attributable to the recapture element of depreciation, the nonrecapture element, or appreciation in value. And the tax treatment of losses from assets and the use of assets will continue to be different. In short, current law's treatment of all assets other than ordinary income assets as essentially fungible items for tax purposes is now dramatically incorrect, thanks to the changes of the 1997 Act.

To illustrate another potentially erroneous outcome involving the mistiming and possible exemption of income under the partnership rules, consider the following example:<sup>252</sup>

*Example 2.* D, E, and F form a partnership to start a computer software business. D and E agree to bankroll the know-how of partner F. F initially takes a profits only interest in the firm. If the partnership were liquidated the day after formation, D and E would split all the money and F would get nothing.

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250. See, e.g., IRC § 732(c)(1).

251. See IRC § 1(h), as amended by the 1997 Act. In addition to the difference in tax rates, the amount of gain subject to tax may also vary, depending upon the asset. See, e.g., IRC § 1202(a) (50% exclusion from gain on sale of certain qualified small business stock) and IRC § 121, as amended by the 1997 Act (\$250,000/\$500,000 exemption from sale of principal residence).

252. Cf. Mark P. Gergen, Reforming Subchapter K: Compensating Service Partners, 48 Tax L. Rev. 69, 99-100 (1992). Again, this example disregards the potential application of the general partnership anti-abuse rule.



During the early years, F is compensated through a modest guaranteed payment, with D and E splitting all losses of the venture. Business begins to look promising for the product being produced by the firm. At that point, the partners have a falling out and decide to split up. The partners book up their capital accounts to reflect the current value of the firm's product and the firm then liquidates F's interest, which is now worth \$500,000. The partnership purchases and distributes to F a \$500,000 collectible desired by F, which F continues to hold after the liquidation. Alternatively, the firm purchases and distributes residential property desired by F worth \$500,000 which F lives in for a couple of years and then sells for cash.

Do any of these events, other than the income from the guaranteed payment, generate any tax consequences to F? True, if F is untaxed, F may end up with a zero basis in the collectible or the residential property following the distribution, but F may be willing to hold onto them for some time, maybe until F's death.<sup>253</sup> And F may sell the residence after living in it for a minimum period of time and avoid paying any tax whatsoever on most or all of the gain from the sale.<sup>254</sup>

In summary, the enormous complexity of the partnership contribution and distribution rules and their continued ineffectiveness, which might foreshadow further change in the rules and even more complication, provide powerful support for more restrictive rules, such as those in subchapter S, for the SPBF system. The following sections consider some possible counter-arguments:

i. *Entity Versus Aggregate Theory of the Firm.*—It might be argued that the S corporation rules are consistent with an entity theory of the firm whereas the partnership rules favor the aggregate or conduit theory. Because the SPBF system involves a simplified version of *conduit* taxation, the partnership and not the S corporation rules should therefore be the appropriate starting model.

In fact, however, neither the S corporation nor the partnership rules are supported by either an aggregate or an entity theory of the firm. An entity theory would suggest that property transfers between the owners and the firm are generally taxable ones with perhaps some relaxation of that result where the firm is a mere alter ego of the owner so that the transfer effects a mere change in form in the owner's investment.<sup>255</sup> But certainly the "alter ego"

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253. See IRC § 732(b).

254. See IRC § 121(a).

255. This is the common explanation for § 351. See *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940).

exception would not support the general rules in the partnership area, which permit virtually any transfer of property between a partnership and partner to be tax-free. Nor would an alter ego or mere change in form exception support the S corporation rule on contributions. Although one might quibble with whether 80% is the appropriate standard for measuring a mere change in form, the S rule permits a tax-free result even though an unrelated *group* of persons is necessary to achieve the 80% controlling interest in the corporation. Certainly, any one person in that group may not have effected a mere change in form in that person's investment, yet that person gets tax-free treatment under current law.<sup>256</sup> In addition, the S corporation rule taxes property leaving the corporation even though the recipient *is* an alter ego of the corporation, such as a sole shareholder.

An aggregate theory of the firm would suggest that transfers between an owner and the firm constitute in substance transfers among the owners. Thus, if a contributor of property is the sole owner, or nearly so, of the firm, one might excuse the existence of a taxable event because the contributor is merely transferring the property to himself or herself. Even that nontaxable outcome is not without some doubt, however, because an important rationale under current law for not taxing unrealized gains or imputed income is the absence of a market transaction to measure accurately those gains and income. If there is at least a semblance of a market transaction, which would be the case in any contribution or distribution other than, perhaps, one occurring in a setting involving a sole owner, then the policy against taxing the transaction is not nearly as compelling. In any event, under an aggregate theory, one would certainly not extend tax-free treatment to the lengths provided by either the partnership or S corporation rules.<sup>257</sup> Under the aggregate theory, a group of investors who join together to pool their respective capital have made a substantial change in their property rights as a result of the pooling and, under normal income tax principles, ought to be taxed.<sup>258</sup>

As we have seen, the historical explanation for the partnership rule was based on the common law understanding of a partnership, unlike a corporation, having no legal existence aside from its partners. But as just noted, pure aggregate principles do not support a completely tax-free result in virtually all transfers between the firm and its owners. Moreover, state law

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256. See Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 3.01, at 3-6 (6th ed. 1994); Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions under Section 351*, 11 Va. Tax Rev. 349, 377 (1991).

257. One would also not tax all distributions from S corporations.

258. This is the theory of the recent expansion of the investment company rules. See *supra* note 216 and accompanying text.

views have continued to evolve away from an aggregate interpretation of the partnership.<sup>259</sup> Finally, as discussed in part II of this article, tax policy considerations rather than “aggregate” or “entity” characterizations of a firm for state law purposes should dictate how the transaction should be taxed.

ii. *Tax Policy Considerations.*—From a tax policy perspective, common justifications for a nonrecognition result like the partnership treatment of contributions and distributions are liquidity and valuation concerns and the potential lock-in effect of an income recognition rule.<sup>260</sup> The absence of a liquid means to pay any tax resulting from a transfer to or from a business is a superficially appealing argument in favor of nonrecognition. The reality, however, is that there is no general liquidity exception to the recognition of income, and there are many instances where the tax system taxes illiquid gains. If the lack of liquidity is considered an overriding concern, the proper course of action would be to require the immediate recognition of gains but to permit the payment of tax to be deferred with interest.<sup>261</sup>

Valuation concerns are a little more worrisome. It is true that, except perhaps where property is transferred between an owner and a wholly-owned firm, valuation of any property transferred is very likely to have occurred. Moreover, in those unusual cases where valuation has not, in fact occurred, the income and character tracing rules such as section 704(c)(1)(A) all carry with them the requirement of immediate valuation.<sup>262</sup> Hence, one could hardly justify a nonrecognition rule based on valuation difficulties if one

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259. Under both the UPA and the RUPA, a partner has no interest in specific partnership property, with the partner's interest in the partnership being classified as personalty, regardless of the nature of the underlying assets. Unif. Partnership Act § 26, 6 U.L.A. 730 (1995); Unif. Partnership Act § 502 (amended 1994), 6 U.L.A. 67 (1995). Thus, a partner who transfers real property to a partnership in exchange for an interest in the partnership has exchanged realty for personalty, which is not even a nonrecognition event under § 1031. See Regs. § 1.1031(a)-1(b).

260. See Karen C. Burke, *Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations*, 63 Ind. L.J. 489, 524-26 (1988); David R. Keyser, *A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation*, 5 Am. J. Tax Pol. 269, 288-94 (1986); Philip F. Postlewaite et al., *A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 Geo. L.J. 423, 471-73 (1986); cf. Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. Cal. L. Rev. 397, 407-11 (1987).

261. Cf. IRC § 453A(c).

262. The capital account rules in the partnership area also require knowledge of the value of property contributed to a partnership. See Regs. § 1.704-1(b)(2)(iv)(b)(2) and (5). Similarly, the partnership basis allocation rules enacted in 1997 require valuations. See IRC § 732(c).

intends to comply with all of the additional rules accompanying an initial nonrecognition result.

Nevertheless, there will be certain instances where the parties have agreed to valuations only in gross terms and not on a property-by-property basis. In those cases, a rule requiring the recognition of gains and losses will cause some difficulty and will inevitably lead to the shaving of income amounts in the taxpayer's favor. A nonrecognition rule relying solely on basis amounts avoids these problems. Although valuation concerns are not significant enough to justify a nonrecognition rule in this instance, they cannot be dismissed out of hand.

Lock-in—the potential deterrent effect a recognition rule would have on the movement of capital into and out of businesses—might initially seem to be a false worry. After all, the cause of the lock-in is the earlier failure to tax gains as they economically accrued. Thus, one could argue that a nonrecognition rule improperly channels capital only in certain directions favored by the rule—for example, the rule encourages the transfer of property to and from a firm instead of the sale of such property to a third party—and extends and increases the lock-in effect for the future. By contrast, a recognition rule terminates the lock-in effect; because it is the realization principle that creates the distortion in the first place, the best solution to minimize distortion is to require the realization and recognition of gains at the earliest feasible moment.<sup>263</sup> A transfer of property to or from a business is a transaction, and often a market transaction, and therefore qualifies as a feasible opportunity to trigger tax consequences. Any concern about the overtaxation of capital generally should be dealt with on a more global scale, such as through the adoption of a consumption tax, rather than in an ad hoc manner through the proliferation of selective nonrecognition rules.

But perhaps that argument is too facile. Given the existence of the realization principle, one might well worry that a general recognition rule would unduly deter transfers of capital to or from businesses. The failure to tax unrealized gains inherent in property retained by the taxpayer, and not transferred, could operate as a powerful disincentive against making the transfer.

The potential importance of the lock-in effect requires judgment regarding the sensitivity or elasticity of the transfer to the resulting tax consequences. To make that judgment, it is necessary to consider the nontax reasons for the transfer. For a transfer of capital to a firm, there would seem to be at least two reasons: the benefits offered by state law features of the

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263. See Keyser, *supra* note 260, at 285; Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *Tax L. Rev.* 1, 28 (1992).

firm (limited liability, for example)<sup>264</sup> and the economic benefits of pooling the property with the capital and services of other investors. In theory, the greater the nontax benefits obtained, the higher the permissible tax cost of the transaction without creating an undesirable disincentive to the movement of capital.<sup>265</sup>

At one time, the nontax benefits obtained from a transfer to an S corporation might have been considered greater than those from a transfer to a partnership. Both transfers offered the pooling advantage,<sup>266</sup> but the S contribution transfer also achieved the important benefits of incorporation. Hence, the partnership area perhaps needed a somewhat more liberal non-recognition rule to be sufficiently responsive to lock-in concerns. In contrast, because of its greater nontax benefits, contributions to an S corporation could face a higher tax barrier. This is not to suggest that this difference between S corporations and partnerships was the basis for the development of their two different rules, but it is a possible way to rationalize their existence.<sup>267</sup>

With the blurring of state law characteristics among the various business forms, however, the advantages of incorporation may no longer be significant. Put another way, transfers to a partnership, an LLC, or another, not yet authorized, unincorporated business form may gradually provide the *same* nontax benefits as transfers to an S corporation. This transformation at the state level, combined with the failure to distinguish private firms for tax purposes based on their organizational characteristics, suggests that the *same* tax rule should apply to property contributions to private business firms, whether they are taxed under the SPBF system or the default version of conduit taxation. Moreover, if the S corporation rule has been adequately responsive to lock-in concerns, it may be an acceptable rule for the SPBF system. At minimum, concerns about lock-in do not provide any compelling case for adoption of the more liberal partnership contribution rule.

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264. Cf. Note, *Losing Control: Toward a New Understanding of the Taxation of Post-Incorporation Stock Sales*, 108 Harv. L. Rev. 1661, 1662 n.7 (1995). By transferring capital to a firm providing limited liability protection, the transferor potentially protects untransferred assets from tort and other liabilities arising from the firm's business operations.

265. See Shaviro, *supra* note 263, at 32-34.

266. We ignore transfers to wholly-owned S corporations because they are tax-free under current § 351. Thus, the only case where the restrictive nature of the S corporation rule (in contrast to the partnership rule) on property contributions might come into play is in cases where there is more than one shareholder.

267. One commentator has suggested that the 80% control requirement in § 351 was inserted solely to prevent corporations with marketable securities from using their stock to buy property, thus shielding their vendors from immediate tax (and possibly transforming ordinary income into capital gain). Because partnership interests are generally not marketable, and certainly were not when the partnership rule was established, the more liberal nonrecognition rule was appropriate for transfers to partnerships. See Jensen, *supra* note 256, at 397.

A similar analysis applies to distributions. The principal nontax benefit of a distribution would seem to be the withdrawal of money or property from the common pool and the resulting ability of the distributee to make investment or consumption decisions directly. Both partnership and S corporation distributions provide this same benefit. On the other hand, at least traditionally, there has been a difference between the nontax consequences of a liquidating distribution by an S corporation and a partnership: only the former has entailed the nontax *disadvantage* of loss of limited liability and other benefits of state law incorporation.<sup>268</sup>

Despite this nontax difference, as we have seen, the tax cost of a distribution by an S corporation is higher than that of a distribution by a partnership. Thus, from a lock-in standpoint, the partnership and S corporation tax rules would seem to be exactly the opposite of what they should be. The S rule, mindful of the somewhat smaller nontax benefits of an S distribution, should impose a *smaller* tax burden than the partnership rule to avoid an undesirable trapping of cash and property within the firm. The fact that the S rule does not do so of course does not justify it as the correct rule for the SPBF system. But it does suggest that lock-in concerns may not be that significant in fashioning the proper rule in this area. And it also offers no compelling justification for adoption of the partnership distribution rule.

A final observation: although the S distribution rules are more restrictive than the partnership rules, the difference between the two should not be overstated. For pro rata cash distributions, the rules are essentially identical.<sup>269</sup> Moreover, if section 751(b) were scrupulously followed by taxpayers—admittedly a highly questionable assumption—many non-pro rata property *or cash* distributions by a partnership may well be caught within its reaches, thereby triggering potential tax consequences to *nondistributees* as well as distributees relating to gains and losses inherent in *undistributed* as well as distributed property. In other words, the partnership tax consequences might be more onerous than the S corporation consequences in many of those transactions. When one further adds the recent bells and whistles of provisions such as sections 731(c), 704(c)(1)(B) and 737, it is evident that many partnership distributions are *not* nonrecognition events. This observation bolsters the notion that the choice between the two sets of rules should not make a significant difference from the standpoint of preventing lock-in.

e. *Summary and Proposals.*—Income recognition rules for contributions and distributions are strongly supported by simplification

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268. "Liquidating" distributions refer to distributions which completely liquidate the distributee's interest in the firm, whether or not the firm itself liquidates in the process.

269. See IRC §§ 731(a)(1), 1368(b).

objectives, a principal concern of the SPBF system. Furthermore, such rules are less vulnerable to taxpayer manipulation than nonrecognition rules such as the partnership rules. In contrast, widespread nonrecognition rules are not supported by either aggregate or entity principles and entail the highest transaction costs. Tax policy considerations also do not dictate strongly in their favor. Therefore, the SPBF system should adopt the following contribution and distribution rules:

i. *Contributions.*—Contributions to an SPBF should follow the S corporation rules with two modifications. First, the 80% control standard should be significantly reduced. Whatever its historical explanation, the standard is too high if the purpose of the rule is to distinguish between real economic exchanges and mere changes in form of ownership of the property contributed. Lowering the 80% standard will also help to mitigate concerns about valuation difficulties and lock-in.

At the same time, the “control group” rule in section 351 should not be adopted for the SPBF system. As previously discussed, the control group rule permits transferors who clearly are achieving a substantial change in their property interests in joining a firm to obtain a nonrecognition result, so long as they join together with others who have a controlling interest in the firm. This result is not justified by either entity or aggregate principles. Not including the control group rule also eliminates the need to define what the group is and avoids the potential surprise to members of the group when one of them is subsequently disqualified.<sup>270</sup>

Dropping the control group rule may also be a necessary step, as a practical matter, if one is serious about requiring the recognition of gains and losses on contributions to an SPBF constituting a real economic change. Consider a minority owner whose contribution of property to an SPBF would ordinarily be taxable due to an insufficient ownership interest in the firm. If there were a control group rule, that taxable result could easily be avoided by having the other owners accommodate the minority owner and make contemporaneous contributions of cash to the firm. Under the proposed rule for SPBF distributions (described next) as well as the current law applicable to partnerships and S corporations, pro rata cash distributions from an SPBF are tax-free to the extent of the distributee’s outside basis. Thus, existing owners with enough outside basis might simply receive tax-free cash distributions and then recontribute the proceeds to accommodate the minority owner. This

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270. Cf. *James v. Commissioner*, 53 T.C. 63 (1969) (disqualification of one transferor caused other transferors to be taxed).

maneuver seems to be possible under existing subchapter S and would also exist in the SPBF system if the control group rule were retained.<sup>271</sup>

ii. *No Section 704(c)(1)(A) Rule.*—For several reasons, no section 704(c)(1)(A) rule is proposed for the SPBF system. First, the rule is needed only where a property contribution to a firm is a nonrecognition event, something that will occur less frequently in the SPBF system than under current partnership tax law. Second, from the Treasury's perspective, the principal purpose of the rule is to prevent the temporary misallocation of tax liabilities among the owners. Eventually, the proper amounts of gain or loss will be allocated to the proper parties. But the SPBF ownership restrictions are designed to limit the advantage of temporary shifts of that nature. Thus, the fisc should be adequately protected even though section 704(c)(1)(A) is not mandated in the taxation of SPBFs.

Third, inclusion of such a rule would introduce administrative complexities inconsistent with the goals of the SPBF system. It would require property valuations on a property-by-property basis in exactly the types of situations—contributions by transferors who own a significant percentage of the firm—where precise valuations may not have been made. It would also be particularly difficult to implement in a tax regime which does not generally permit special allocations. Moreover, to be wholly effective, any such rule would also need to overcome the ceiling rule problem and to apply to reverse section 704(c) situations, both of which would introduce even more complication. Finally, although the issue arises under current subchapter S, we take some comfort in the fact that the Treasury has managed to survive without importing section 704(c)(1)(A) principles into that area.

Some thought was given to returning to pre-1984 law for SPBFs and to allowing the section 704(c)(1)(A) adjustment to be an option for the taxpayers. The reason is that the adjustment may be a desirable one for owners who fail to take into account in their economic dealing the difference in the tax quality of their respective contributions.<sup>272</sup> Thus, for such owners, a section 704(c)(1)(A) election could relieve a hardship. But elections are inconsistent with a goal of keeping the system simple. What may be relief for some may turn out to be an attractive nuisance for many others. In addition, it was unclear how common the hardship situation actually arises. At least for

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271. It may be appropriate to fashion a tax-free exception for certain contributions to firms for which capital is not a material income-producing factor. This rule would allow, for example, a service partner who combines his or her firm with an existing service partnership to avoid being taxed on the contribution of goodwill even though the transferor does not end up with a sufficient ownership interest in the combined firm to qualify for tax-free treatment under the general rule.

272. See Berger, *supra* note 63, at 143-46.



regular section 704(c)(1)(A) cases, the issue only comes up when there is a noncash contribution to a firm, which necessarily requires the parties to make some determination of the value of the property contributed. Because value determinations are much more difficult than basis determinations, if the parties can satisfactorily reach agreement regarding value, it may be reasonable to expect that they will take into account basis information in their economic deal as well. This might be particularly true under the proposed SPBF rule for contributions, which permits a nonrecognition result only where the contributor has some significant interest in the firm following the contribution.

iii. *Distributions.*—Deciding on distribution rules for the SPBF system that properly balance all of the competing considerations has been difficult. The foregoing discussion supports SPBF rules more restrictive than the partnership rules, but it does not indicate how restrictive they should be.

This article proposes that distributions by an SPBF generally follow the subchapter S rules but again with certain modifications. First, like current partnership law and unlike current subchapter S, the taxation of distributees should be determined by just two categories of distributions, liquidating and nonliquidating. No special rule shall be provided for partial liquidations.<sup>273</sup> In a nonliquidating distribution, a distributee shall recognize gain only to the extent the amount of the distribution exceeds the distributee's outside basis. No loss shall be recognized. In a liquidating distribution, a distributee shall recognize gain or loss in the same manner as a sale or exchange of the ownership interest. As under current law, in determining the tax consequences of the distribution to the distributee, the distributee's outside basis should first be adjusted for any gain or loss recognized by the SPBF in the distribution and passed through to the distributee.<sup>274</sup> In general, distributees shall obtain fresh start fair market value bases in any property distributed.

Failure to include a partial liquidation rule might seem to create a tax disparity between such a transaction and a sale by the owner of a portion of his or her ownership interests to a third party. In the former transaction, there would not be any required allocation of basis in computing gain whereas in the latter, there would be. But the two transactions may not be exactly alike because only the distribution results in a withdrawal of funds from the firm. In addition, the rules differentiating ordinary distributions from partial liquidations under current law are generally designed to prevent the former

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273. Compare IRC § 302(a). Again, the term "partial liquidation" is used here to refer to a distribution which effects a partial redemption of the distributee's interest. See *supra* note 223.

274. See IRC § 1368(d).

from being disguised as the latter.<sup>275</sup> In contrast, in the SPBF system as in existing subchapter S, tax advantage would be gained from the opposite strategy, which the existing rules are ineffective at stopping.<sup>276</sup> Thus, as a practical matter, preservation of a partial liquidation rule may serve little purpose.<sup>277</sup>

The other modification to the S distribution rules involves a nonrecognition exception in the SPBF system for distributions constituting a mere change in form of ownership of the property distributed. This exception turns on the percentage ownership of the distributee in the SPBF immediately prior to the distribution, and the percentage may or may not be the same as for the nonrecognition rule in the case of SPBF contributions.<sup>278</sup> Where the exception applies, the SPBF does not recognize any gain or loss. The distributee also does not recognize any loss but must recognize gain to the extent money plus the basis of any property distributed exceeds the distributee's basis in the SPBF prior to the distribution. This rule is necessary to prevent the distributee from obtaining basis without the recognition of a commensurate amount of income. The distributee inherits the SPBF's basis in any property distributed, and the distributee's outside basis must be reduced by the money and the basis of any property distributed.

*Example 3.* Immediately prior to a nonliquidating distribution, A owns 90% of the residual interests of an SPBF with an outside basis of \$100. Assume the percentage interest is high enough to qualify for the nonrecognition exception. In the distribution, A receives property worth \$150 and with a basis to the SPBF of \$30. Under the exception, neither the SPBF nor A recognizes any gain or loss in the transaction. A takes a \$30 basis in the property distributed and reduces outside basis to \$70.

*Example 4.* Same facts as in example 3 except that the SPBF had a \$130 basis in the property distributed to A. Under the nonrecognition exception, the SPBF still does not recognize any gain or loss. A, however, must recognize \$30 of gain, the excess of the SPBF's basis

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275. See IRC § 302.

276. For example, the distributee might retain an option to acquire the necessary percentage of ownership interests to prevent a distribution from satisfying the numerical standard for a disproportionate redemption. Cf. IRC §§ 302(b)(2) and (c)(1), 318(a)(4).

277. Professor Eustice has recommended elimination of the partial liquidation rule for S corporations. See Eustice, *supra* note 175, at 406.

278. Different percentages might be justified if, for example, it were considered more problematic to discourage property contributions to an SPBF than distributions from such firms.

in the property distributed (\$130) over A's pre-distribution outside basis (\$100). A takes a \$130 basis in the property distributed and A's outside basis is reduced to zero.

An SPBF may elect to have the foregoing exception not apply. An election is needed because there is one case in which the exception would produce an unfavorable result for taxpayers. In a liquidating distribution where the distributee's basis in the SPBF is greater than the money and basis of property distributed, the exception causes the distributee to lose basis. This case is illustrated by the following:

*Example 5.* Same facts as in example 3 except that the distribution liquidates A's interest in the firm. Also, assume that A's outside basis in the SPBF just prior to the distribution is \$150. Under the nonrecognition exception, no gain or loss is recognized to either A or the firm and A inherits the firm's basis of \$30 in the property distributed. \$120 of A's pre-distribution outside basis has disappeared.

Some thought was given to permitting A to receive a \$120 capital loss in this situation. This would be the mirror image of the rule where the distributee's pre-distribution outside basis is less than the money plus the basis of any property distributed. As noted, in that case, the distributee is required to recognize gain equal to the excess.

Recognition of a capital loss to A might, however, create certain tax avoidance opportunities. Step back a moment and assume that B previously owned the property distributed in example 5, with value of \$150 and basis of \$30, and was prepared to sell it to A for \$150. Assume the property qualified as a capital asset to B so that a straight sale of the asset would have resulted in \$120 of capital gain to B and a \$150 cost basis in the asset to A. Instead, B contributes the asset tax-free to an SPBF in exchange for 90% of the residual interests, and then sells the 90% interest to A for \$150. On the sale, B recognizes the same \$120 capital gain. If the subsequent liquidating distribution of the property to A allowed A to claim a capital loss, then A would receive a \$120 capital loss and a basis in the asset of \$30. In contrast to the results of the straight sale, A has basically deducted immediately \$120 of the investment. True, the deduction is only a *capital* loss but if A has capital gains which need sheltering, this might be an attractive deal.

Consideration was also given to providing A with an exchanged basis in the asset distributed rather than a transferred basis whenever the exception applies. For example, in example 5, A would not recognize any gain or loss and would simply receive a \$150 basis in the property distributed. Current

partnership tax law generally follows this approach<sup>279</sup> but it raises many difficult questions. For instance, should there be any tax consequences to the SPBF, either in terms of income recognition or reduction in basis of other assets, to reflect the increase in the asset's basis from \$30 to \$150?<sup>280</sup> If the SPBF were required to recognize income, how should its character be determined? If inside basis were reduced, how should the decreases be allocated?<sup>281</sup> And if more than one asset were distributed, or some combination of money and assets, how should the distributee's outside basis be allocated among the properties received?<sup>282</sup> It seemed unlikely that these and other questions could be satisfactorily resolved without a degree of complication inconsistent with the goals of the SPBF system.

In contrast, application of the proposed general rule for distributions would seem to provide the taxpayer with a perfectly acceptable result:

*Example 6.* Same facts as example 5, except that the SPBF elects out of the special exception. Under the general rule for distributions, the SPBF must recognize \$120 in capital gain on the liquidating distribution and such gain is passed through to A, increasing outside basis to \$270. Thus, A would also recognize a \$120 capital loss on the distribution, which would offset the \$120 passthrough gain. A would receive a fair market value basis of \$150 in the asset distributed.

This result is exactly the same as the one that would have been obtained by A had the transaction involved the straight purchase and sale of the asset with B.

Although an election introduces its own complexities, it would seem to be the simplest solution in this case. The "mere change in form" exception is intended as a relief provision and where it produces an undesirable result, taxpayers should be provided with a way out of it. Failure to provide an explicit election would simply give advantage to the well-advised who would "elect" out in a transactional manner. Because in most cases, however, the exception would be advantageous to taxpayers, the proposal provides that taxpayers must affirmatively elect out of the exception.

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279. See IRC § 732(b).

280. Under partnership law, if a § 754 election is in effect, the partnership would have to reduce its basis in other assets by the \$120. See IRC § 734(b)(2)(B).

281. Under partnership law, basis reductions must generally be allocated to partnership property of "like character" to the property distributed, although there are anomalies in the allocation process. See IRC § 755.

282. The partnership law rules are provided by § 732(c), as amended in 1997.

iv. *Other Rules Not Included.*—In view of the proposed rules for SPBF contributions and distributions, sections 704(c)(1)(B), 737, and 731(c) are unnecessary and not included in the SPBF system. Although section 751(b) is not made completely superfluous by the proposals—for example, a non-pro rata cash distribution might trigger tax consequences under that provision but not under existing subchapter S—it is also not included in the SPBF system. Discussion of section 751(b), however, as well as whether sections 724 and 735 and the collapsible corporation rules should be included in the SPBF system, is included in a following section.

Certain highly publicized transactions continue to justify the need for effective disguised sale rules.<sup>283</sup> In addition, at a much less publicized level, there appears to be widespread noncompliance in that area. In a recent poll, a cross-section of accountants were asked to identify their prime targets for IRS audit if they were to receive compensation equal to a percentage of any additional tax discovered. Somewhat astonishingly, the “use of partnerships to defer taxation of disguised sales” was among the top five targets identified, along with such common areas of noncompliance as nanny tax situations and disguised dividends.<sup>284</sup>

The need for disguised sale rules is much reduced in the SPBF system. To the extent the transaction involves a property transfer to or distribution from an SPBF which is taxable under the proposed rules for contributions and distributions, a disguised sale transaction obviously does not work. Another common technique is to use special allocations to effect the disguised exchange of economic interests but the SPBF rules specifically restrict the availability of special allocations.<sup>285</sup>

But the need for anti-disguised sale rules in the SPBF system is not completely eliminated. For example, a contribution of appreciated property to an SPBF by an owner with a sufficient interest in the firm might be followed by a cash distribution to the transferor not exceeding the transferor's basis in the property contributed. If respected, both transactions would be tax-free under the SPBF rules (as well as under existing subchapter S) even though they may together constitute the economic equivalent of a partial sale of the property contributed. Another possible disguised sale opportunity under the proposals is where both a contribution and distribution of property are

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283. See Lee A. Sheppard, *Using LLCs for Disguised Dividends*, 76 *Tax Notes* 1524 (Sept. 22, 1997) (describing attempted tax-free sale of hundreds of millions of dollars worth of Times Mirror stock through use of disguised sale technique with an LLC).

284. See Burgess J.W. Raby & William L. Raby, *Tax 20 Forum: An Audit “Hit List,”* 75 *Tax Notes* 105 (Apr. 7, 1997).

285. The proposal does allow an SPBF to have preferred interests. However, preferred returns are less likely to cause concern under the disguised sale rules. See Regs. § 1.707-4(a)(2).

tax-free due to the transferor and the distributee having a sufficient ownership interest in the SPBF.

On balance, the reduced need for disguised sale rules in the SPBF system does not justify retention of such complicated provisions, and they are not included in the SPBF system. In the two cases just described, normal step transaction and other substance over form principles should adequately protect the interest of the fisc. For example, a cash distribution linked to a prior contribution of appreciated property should be considered boot received in the initial transaction which will cause the recognition of gains.<sup>286</sup> Although there is no doubt that some disguised sales will escape recharacterization under substance over form principles, it would appear that, as described above, the more elaborate partnership rules have also not been wholly effective. Finally, we again take some solace in the fact that subchapter S has managed to function without any such rules.

v. *Relation to Default Conduit System.*—Finally, the proposed income recognition rules for contributions and distributions within the SPBF system must be compared to the taxation of comparable transactions under the default conduit version. For example, if the default version were to include the partnership nonrecognition provisions on contributions and distributions, taxpayers might be discouraged from using the SPBF system.

The various factors described above concerning the proper contribution and distribution rules are applicable to the default system as well as the SPBF system. Although simplification may be a higher priority for the SPBF system, it is certainly an important consideration for the default system as well. Further, no system benefits from a rule structure which can be easily manipulated by the taxpayer. And the default system is particularly vulnerable to potential manipulation because of the absence of any ownership restrictions and limitations on special allocations. In short, perhaps the easiest way to reconcile the two systems in this area would be to adopt the same basic rules in each system for contributions and distributions. The need for additional rules may then vary depending upon the peculiar features of each system.

#### 4. *Treatment of Ordinary Income Assets of an SPBF*

a. *Sections 751 and 341 Not Included in the SPBF Rules.*—The partnership provisions contain elaborate rules to insure that a partner's interest in potential ordinary income of the partnership is reflected

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286. Cf. IRC § 351(b). See Berger, *supra* note 63, at 151-52 (suggesting that the step transaction doctrine would prevent the transaction from succeeding).

in the character of the gain the partner recognizes in disposing of an interest in the partnership.<sup>287</sup> These rules also try to prevent character shifting among the partners as a result of a distribution.<sup>288</sup> On the other hand, if the correct proportion of ordinary income and other assets (determined by *value* of the assets) is distributed, no attempt is made to be sure that the assets distributed have the same mix of unrealized ordinary income or loss as the underlying assets of the partnership.<sup>289</sup>

These "collapsible partnership" rules governing the treatment of ordinary income assets held by a partnership are among the most complicated in the Code. Moreover, unlike rules such as Subpart F in the foreign tax area or the consolidated return regulations, these rules apply to many taxpayers with very simple business arrangements and relatively unsophisticated advisors. The result, not surprisingly, is a common assumption that these rules are often honored in the breach.

The collapsible partnership rules apply to transfers of partnership interests and to distributions from partnerships. The rules governing transfers are in some ways easier to understand than the rules governing distributions. They essentially insure that the transfer of a partnership interest be viewed as a transfer of the underlying assets in order to preserve the character of gain or loss inherent in the transfer. But the rules governing distributions are of equal importance in preventing the use of the partnership structure to avoid the proper characterization of income at the partner level. It would not be possible to adopt the rules for transfers without some rules for distributions.

As previously described, a distribution of property by an SPBF would be taxable in more instances than a comparable distribution by a partnership. This change reduces but does not eliminate the theoretical need for a collapsible partnership rule in a distribution. For example, a non-pro rata distribution of cash by an SPBF with ordinary income assets would generally not be taxable under the SPBF proposal yet it may shift some of the potential ordinary income tax liability from one owner to another.

Some of the complexity of the collapsible partnership rules derives from the broad definition of assets that are covered by the rule. Although the statute speaks of unrealized receivables and either inventory (in the case of transfers of partnership interests<sup>290</sup>) or substantially appreciated inventory (in the case of distributions<sup>291</sup>), the provisions apply to portions of assets and to expectancies in a way that only a well-advised firm could possibly be expected to follow.

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287. See IRC § 751(a).

288. See IRC § 751(b).

289. See McKee, Nelson & Whitmire, *supra* note 202, ¶ 21.01[2] at 21-6 - 21-7.

290. See IRC § 751(a)(2).

291. See IRC § 751(b)(1)(A)(ii).

But the complexity of the provisions goes beyond those details because they require taxpayers to trace through the consequences of complicated transactions that are created by the statute alone. It is hard to imagine such a structure being applied correctly by any but the most well-advised taxpayers.

S corporations are not subject to the collapsible partnership rules. On the other hand, they are subject to the infamous "collapsible corporation" rules (section 341), which the American Law Institute has previously described as "characterized by a pathological degree of complexity, vagueness and uncertainty."<sup>292</sup> Where it applies, section 341 treats as ordinary income any capital gain from the sale of an S corporation's stock or from a distribution treated as a sale or exchange.<sup>293</sup> The provision is a close brethren of the collapsible partnership rules, both in terms of purpose and complexity.

It therefore seems inevitable that neither of these rules will be included in any simple regime such as the SPBF system. The question is whether it is necessary to preserve some part of them in order to avoid abuse of the SPBF structure. Consider the following example:

*Example 7.* Taxpayer G owns an asset with a significant amount of unrealized ordinary income. G transfers the asset to an SPBF in exchange for an ownership interest in the firm. G subsequently sells the interest to H, recognizing capital gain on the sale.

One small way the proposed SPBF rules would prevent this transaction is by restricting the instances in which G could transfer the asset tax-free to the firm. A more important protection, however, is the ownership limitations of an SPBF. To the extent the owners of an SPBF are in roughly the same tax position, concerns that one taxpayer may avoid some tax at the expense of another owner may be minimized. In other words, as long as the issue is the proper *allocation* of income character among the owners, the SPBF ownership rules may provide adequate protection without the need for a special set of rules.

Thus, example 7 should not lead to major tax avoidance if H (and any other owners of the firm) can be expected to pay tax at roughly the same rate G would have been subject to.<sup>294</sup> So long as the unrealized ordinary

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292. American Law Institute, Proposals of the American Law Institute on The Income Taxation of Corporate Acquisitions and Dispositions, A.L.I. Federal Income Tax Project, Subchapter C 111 (1982).

293. See IRC § 341(a).

294. If H were not a permissible owner of an SPBF, then eligibility for the simplified system would end with the sale. We have not worked out all of the consequences of a transition from the SPBF system to the default conduit system, but presumably one



income remains in the SPBF following the sale, some future owner will have to pay tax on it. As described in the next section, no inside basis adjustment is authorized upon sale of an SPBF ownership interest. Thus, any unrealized income of the SPBF should ordinarily remain inside the firm following such a sale. Indeed, under those circumstances, one might even expect H's purchase price for the ownership interest to reflect to some extent the lurking ordinary income tax liability inside the firm.

A similar analysis applies to distributions. If a non-pro rata distribution of cash to one owner leaves behind a disproportionate amount of the firm's ordinary income tax liability for another owner, one might presume that the fisc will come out about the same if the two owners are in roughly the same tax position.

In a rough way, Congress has shown acceptance of this theory through enactment of section 341(f). In general, that provision allows a shareholder to recognize capital gain upon the sale of stock of a collapsible corporation on condition that the corporation recognize any unrealized ordinary income at some future point in time. In other words, as long as *someone* pays tax on the ordinary income—either the remaining shareholders of an S corporation or the corporation itself in the case of a C corporation—the concern of the collapsible corporation rules is satisfied. Moreover, unlike the protection offered by the SPBF ownership rules, the section 341(f) election is not conditioned on whether the ultimate taxpayer is in the same tax position as the shareholder who sold the stock.<sup>295</sup>

To be sure, this Pollyannish approach to taxing SPBFs will not be justified in every case. But even the full panoply of current subchapter K does not prevent taxpayers from structuring transactions that fulfill the requirements of the Code and yet appear to be inconsistent with the intent of this subchapter.<sup>296</sup> Furthermore, rules are only as effective as their voluntary, correct observance by taxpayers or their proper enforcement by the IRS, both of which being matters of serious doubt when it comes to provisions such as the collapsible partnership and corporation rules. Although some abuses will no doubt remain in the SPBF system, the goal of the

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consequence would be the application of the normal default system rules to the terminating transaction. Thus, if § 751(a) were part of the default system, it would potentially recharacterize G's gain on the sale from capital gain to ordinary income.

295. The rule may, nevertheless, have that general effect. C corporations with taxable income of \$75,000 or more are taxed near the highest individual rates. And S corporations have approximately the same ownership restrictions as an SPBF. Of course, the § 341(f) election is nonsensical in today's world with the repeal of *General Utilities*: the taxpayer gets a benefit by having the corporation agree to do something—recognize corporate-level income—which is already required by law.

296. See N.Y.S.B.A. Tax Section Report, *supra* note 67. See also Regs. § 1.701-2(d), exs. 7, 8; T.D. 8588, 1995-1 C.B. 109 (preamble to original version of Regs. § 1.701-2).

structure is to *balance* the needs of the fisc with the desire to have a system that can be applied by the taxpayers who elect to use it. Omitting the collapsible partnership and corporation rules from the SPBF structure may lead to the shifting of some ordinary income and capital gain among owners of an SPBF, but should not lead to widespread tax avoidance. Accordingly, sections 751 and 341 are not included in the SPBF system.

b. *Character Continuation Rules.*—A different issue altogether arises if a transaction permits the *conversion* of ordinary income into capital gain, rather than the mere misallocation of such items. The SPBF ownership restrictions provide no protection against this advantage.

Conversion opportunities arise because, under the normal rule for conduit taxation, the character of income is determined by the firm and then passed through to the owners.<sup>297</sup> Thus, an owner with an asset containing unrealized ordinary income might contribute the asset to an SPBF in a tax-free manner and then have the firm recognize the income. If the firm's income were properly characterized as capital gain, the ordinary income tax liability would be lost forever. Similarly, an SPBF holding an asset with unrealized ordinary income might distribute the asset to an owner in a tax-free manner. Again, if the distributee's recognition of the income were capital gain, the ordinary income tax liability would be lost forever.

The proposed contribution and distribution rules for an SPBF narrow the instances of this problem by restricting how often such transactions will be nonrecognition events. But under the proposals, certain contributions and distributions will still be tax-free. When they are, the ordinary income character of an asset in the hands of the SPBF and the distributee following a contribution and distribution, respectively, will be preserved. These rules are embodied in current sections 724 and 735 applicable to partnerships. For the SPBF system, those two rules are adopted but simplified by limiting their application to traditional ordinary income items (e.g., inventory items and accounts receivables) and ordinary income recapture items.

## 5. *Inside Basis Adjustments*

a. *In General.*—If a partnership makes an election under section 754 of the Code, any transfer of an interest in the partnership results in a set of adjustments for the transferee with respect to the bases of assets held by the partnership; the adjustments will generally bring the bases of

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297. See IRC §§ 702(b), 1366(b). The SPBF proposals follow this rule. See *supra* Part IV.C.2.a.

those assets attributable to the transferee closer to their fair market values.<sup>298</sup> Similarly, if a section 754 election is in effect at the time of a partnership distribution, adjustments are made under section 734(b) to the bases of the assets of the partnership to take account of any discrepancies between the pre-distribution basis of any distributed asset in the hands of the partnership and the post-distribution basis of such asset in the hands of the distributee.<sup>299</sup> The rules of subchapter S have no provision comparable to section 754.

b. *Adjustments Made on Distributions of Property.*—In the case of distributions of property, the adjustments made under section 734(b) that are based on discrepancies between the pre-distribution inside basis of property distributed and the post-distribution basis of such property in the hands of the distributee are not necessary as a result of the proposed SPBF treatment of distributions. Under that proposal, a distribution results either in the recognition of gain or loss by the SPBF, with accompanying fair market value basis to the distributee in the property distributed, or a pure transferred basis to the distributee equal to the firm's pre-distribution basis.

Section 734(b), however, also applies when the distributee recognizes gain or loss on a distribution and this situation could arise in the SPBF system:

*Example 8.* A, B and C contribute \$10,000 each to an SPBF and take back equal shares of the firm. The firm purchases for \$18,000 an asset which increases in value to \$24,000. At that time, the SPBF distributes \$12,000 to A in liquidation of A's interest. Under the SPBF distribution proposal, A must recognize a \$2,000 gain. If a section 754 election were available and in effect, the basis of the firm's asset would be increased by the \$2,000 gain recognized by A. Thus, if the asset is subsequently sold by the SPBF for \$24,000, there would be only \$4,000 gain recognized, allocated \$2,000 each to B and C. Without that basis adjustment, the firm's gain on the sale would be \$6,000, allocated \$3,000 each to B and C.

The failure to adjust basis if there were no section 754 election available or in effect does not create a permanent mismeasurement of the amount of gain or loss to be recognized by the remaining owners. In the example above, absent a section 754 election, the \$6,000 gain passed through to B and C increases their outside bases by \$3,000 apiece. If the SPBF were

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298. See IRC §§ 743(b), 755.

299. See IRC §§ 734(b), 755.

liquidated at that time and each of them received a distribution of \$12,000, each would recognize a \$1,000 loss. Thus, when there is no section 754 election made, the effect is on the timing of income.

Although there is no equivalent of section 751 in the SPBF rules, the absence of a section 754 election will not affect the character of the income recognized to the owners as a group. In the example above, if the asset owned by the SPBF would generate ordinary income, A would nevertheless recognize a \$2,000 capital gain on the liquidation of the SPBF interest (assuming it is a capital asset in A's hands). This is a consequence of the absence of section 751. However, because there is no section 754 available, the firm will recognize the full \$6,000 gain as ordinary gain, and C, as well as B, will have \$3,000 of ordinary income as a result. Presumably, the parties can take this into account in fixing a price necessary to liquidate A's interest. Of course, if the asset had decreased in value, resulting in a distribution of less than \$10,000 to A, the effect would have been an acceleration of capital loss (but no ordinary loss) to A, while B and C would have received an allocation of more ordinary loss than they would strictly "deserve."

Section 754 elections make the conduit rules operate more precisely. However, they do so in a way that involves substantial complexity for those who must comply with the tax provisions. It seems likely that many SPBFs would not rigorously apply the rules of sections 754 and 734(b) even if the opportunity were available to them. Furthermore, the proposed distribution rules for the SPBF system makes the election less necessary in the case of an SPBF distribution than under subchapter K. In order to make the SPBF system more manageable for those who elect it, no section 754 election is provided for in a distribution.

*c. Adjustments Made on the Sale of Ownership Interests.*—When a section 754 election is in effect, upon a sale of a partnership interest, the transferee receives special basis adjustments with respect to the partnership assets attributable to the transferred interest.<sup>300</sup> As a result, the transferee is not required to pay tax on unrealized gain that the transferee has, in effect, already paid for.

As with the adjustment on distributions, omitting the adjustment on a sale changes the timing of the recognition of income:

*Example 9.* Same facts as in example 8, except that instead of liquidating A's interest, A sells it to buyer D for \$12,000, its fair market value. A recognizes a \$2,000 gain on the sale. If a section 754 election were available and in effect, D would receive a special

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300. See IRC §§ 743(b), 755.

\$2,000 upward basis adjustment with respect to the firm's appreciated asset (one-third of the \$24,000 fair market value less one-third of the \$18,000 basis). Thus, if the asset is sold by the firm for \$24,000, D's \$2,000 share of the firm's \$6,000 gain would be completely offset by D's special \$2,000 basis adjustment.

In example 9, when no section 754 election is in effect, D's \$2,000 share of the gain on the sale of the asset results in a larger outside basis in the firm. Thus, when D sells the interest in the firm, D will have less income than had a section 754 election been in effect. The increased income at the time the asset is sold is matched by decreased income when the SPBF interest is sold.

Despite the benefits that the precision of section 754 affords in the case of a transfer of ownership interests, the cost in terms of complexity is quite great. Unlike the adjustments on a distribution which can be made to the general basis of the firm, the basis adjustments on a sale are unique to particular owners. In example 9, the \$2,000 basis adjustment belongs to D only; B and C would be taxed incorrectly if the general basis of the firm in the asset were increased by \$2,000 and the three owners subsequently split equally the resulting \$4,000 gain upon sale of the asset.<sup>301</sup> In addition, if the firm has many assets, the total basis adjustment must be allocated among those assets. If there are multiple sales, it will have to keep track of separate sets of such adjustments for different owners. Moreover, it will have to remember to apply all of the adjustments correctly in calculating and allocating gains and losses of the firm on future sales.

The timing problems that arise when no section 754 election is permitted have been tolerated in the subchapter S context. Because of the proposed SPBF distribution rules, there should be no permanent effect on the amount of income recognized.

Not allowing a section 754 election can give individual owners tax consequences that are not precise. However, those consequences can to some

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301. But see Prop. Regs. § 1.743-2(a) allowing a special basis adjustment with respect to only one partner to be taken into account as a *general* partnership basis adjustment when partnership assets are deemed contributed to a corporation pursuant to an elective conversion from partnership to association tax status. (Under Prop. Regs. § 301.7701-3(g)(1)(i), if a partnership elects to be classified as an association for tax purposes, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association, followed by an immediate liquidation of the partnership and distribution of such stock to the former partners.) In the deemed contribution of assets to a corporation, the corporation's basis in the assets contributed generally takes into account any special basis adjustments belonging to individual partners. Prop. Regs. § 1.743-2(a). The individual partners also preserve their special basis adjustments in determining their basis in the corporate stock received in the exchange. Prop. Regs. § 1.743-2(c) (2d sentence).

extent be predicted at the time of a purchase, and, at least in theory, adjustments can be made to the purchase price to accommodate those consequences. In any event, the benefits of the simplicity of the SPBF system should prove attractive enough to make taxpayers willing to adopt the SPBF structure despite this imprecision.

The absence of the section 754 election also permits manipulation by the owners of some of their tax consequences. But because section 754 is elective under current law, that possibility already exists.<sup>302</sup> True, the absence of section 751 in the SPBF structure makes this manipulation potentially more serious. Yet the manipulation is primarily a problem to the fisc to the extent taxpayers with significantly different tax profiles are willing and able to join together in an SPBF. If the SPBF qualification rules are sufficiently stringent generally to prevent that phenomenon, the benefits of the simplicity of the SPBF system outweigh the cost of an occasional abuse.

In summary, the SPBF system does not provide for inside basis adjustments in the case of transfers of SPBF interests or distributions by an SPBF.

6. *Conversions/Reorganizations of Firms From One System to Another.*—The proposals described in this article would tax general business firms in three ways. Private firms qualifying as SPBFs would be taxed at their election under either the SPBF system or the default conduit system. All other private firms would be subject to the default conduit system. Finally, public firms would continue to be taxed under subchapter C. This section sketches out some preliminary considerations in ascertaining the tax consequences of a firm moving from one system to another. The movement may occur as a result of an elective conversion (for example, an SPBF electing to leave the SPBF system and to be taxed under the default conduit system) or a reorganization of some sort (for example, a public firm acquiring a private firm in a transaction qualifying as a reorganization under current law).

a. *Private Firm (Either SPBF or Default System) to Public Firm (Subchapter C).*—The movement from one of the private firm tax

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302. See Regs. § 1.701-2(d), ex. (8) and (9) (describing manipulative possibilities under current subchapter K if no § 754 election is in effect). The *ACM Partnership* transaction also would not have worked had there been a § 754 election in effect. See *supra* note 88. Strategic planning may help to prolong the benefit. Cf. Louis S. Freeman & Thomas M. Stephens, *Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities*, 68 *Taxes* 962, 995 (1990). Finally, imprecision in the § 755 basis allocation rules creates planning opportunities. See Andrews, *supra* note 67, at 25-37.

systems to subchapter C involves a change from a conduit tax system to a double tax system. As such, this type of transaction would seem to be a good candidate for liberal tax-free treatment. Current law generally achieves this result. For example, there are no tax consequences if a private C or S corporation goes public; in the latter case, the corporation simply loses its S eligibility and is thereafter taxed under subchapter C. In addition, both a private C and S corporation may be acquired by a public corporation in a tax-free reorganization.

Firms taxed under subchapter K cannot convert to public C status quite as easily as private corporations, and cannot reorganize directly with public C corporations, but they can accomplish the same general results with adequate advance planning. For example, the IRS generally respects the form chosen by the taxpayer for incorporating a partnership, with tax-free treatment being the general consequence, although the specific tax results vary slightly among the techniques.<sup>303</sup> Once incorporated, the firm may go public or, with sufficient delay, the former partnership may then participate in a tax-free reorganization with a subchapter C corporation. Certain publicly traded partnerships are also automatically treated as corporations for tax purposes and taxed under subchapter C.<sup>304</sup>

While the substantive outcomes of firms moving from private C, subchapter K, or subchapter S status to public C status are therefore alike, the manner of achieving those results under current law are different. There does not seem to be any good policy reason for preserving these differences, with their accompanying increase in planning and transaction costs. Hence, this article proposes generally to allow movement of a firm from the SPBF or default conduit system to subchapter C to be accomplished in a tax-free manner, whether the transaction is carried out as a conversion or reorganization. Thus, for example, if an SPBF converts to public C status or is acquired by a public C corporation in a transaction qualifying as a reorganization, and in the process, the SPBF liquidates, no gain or loss should be recognized by the SPBF or its owners in the liquidation.

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303. Under Rev. Rul. 84-111, 1984-2 C.B. 88, if the partnership transfers its assets, subject to its liabilities, to a new corporation and then liquidates, the transfer to the corporation is governed by § 351 and the liquidation of the partnership is governed by § 731 and § 732 (taking into account the effects of § 752). If it liquidates, and then its partners transfer the assets and liabilities to a new corporation, the liquidation is governed by § 731 and § 732 (taking into account the effects of § 752), and the transfer to the corporation is governed by § 351. If the partners transfer their partnership interests to a new corporation, which causes the partnership to terminate as a matter of law, the transfer is governed by § 351 (taking into account the effects of § 752), and the liquidation is governed by § 731 and § 732.

304. See IRC § 7704(a).

b. *Public Firm (Subchapter C) to Private Firm (Either SPBF or Default System).*—In contrast to a private-to-public transaction, a public-to-private transaction places the integrity of the double tax system in jeopardy because all private firms are taxed under the proposal as conduits. When the situation arises under current law, the double tax obligations are generally either triggered in the transaction or preserved. For example, conversion of a corporation into a partnership for tax purposes is treated as a taxable liquidation of the former.<sup>305</sup> Conversion of a C corporation into an S corporation gives rise to the potential applicability of the built-in gains and passive investment income taxes under subchapter S.<sup>306</sup> In general, those two provisions authorize the subsequent taxation of the firm's accumulated subchapter C earnings and profits and built-in subchapter C gains in certain circumstances.

The built-in gains and passive investment income provisions, however, offer incomplete protection for the double tax system. For example, the built-in gains tax applies only when there is a net built-in gain in the assets of the corporation at the time of the conversion. No attention is paid to the likelihood of any built-in gains or losses being recognized in the future, or to the character of such gains and losses. And exposure to the tax is limited to a ten-year period. The passive investment income provision merely attempts in a very rough way to limit the ability of a firm to delay the shareholder tax on subchapter C distributions. In addition to being incomplete, both provisions also introduce undesirable complexity into the rule structure.

A public-to-private transaction may be relatively infrequent but when it occurs, it generally represents a fundamental change in the nature of the firm. Currently, the tax system treats far less significant changes as taxable events.<sup>307</sup> It therefore seems appropriate to treat a public-to-private transaction as a taxable event, thereby protecting better the integrity of the double tax system and avoiding the complexity of provisions such as those found in subchapter S. This rule would be similar to current proposals to treat

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305. Proposed amendments to the check-the-box regulations adopt this approach if the change in the tax status of the firm is made by election. See Prop. Regs. § 301.7701-3(g)(1)(ii). Liquidation treatment occurs even though the corporation is a private C or subchapter S firm.

306. See IRC §§ 1374, 1375. The S corporation is also more vulnerable to loss of its subchapter S eligibility if the firm has a subchapter C history. See IRC § 1362(d)(3). These rules apply regardless of whether the subchapter C corporation was public or private.

307. See, e.g., Regs. § 1.1001-3 (rules for determining whether a modification of the terms of a debt instrument receives exchange treatment under IRC § 1001).



conversions of large C corporations into S corporations as complete liquidations for tax purposes.<sup>308</sup>

One public-to-private transaction under current law—a public C corporation going private but remaining under subchapter C—is not a taxable event. Further, if the public-to-private change results merely from an inadvertent crossing of the public/private line, the change may not even be a very significant one for the firm.<sup>309</sup> The proposals do not provide a comparable way to address this hardship case because they do not permit private firms to be taxed under subchapter C. One narrow solution to this problem is to allow any public firm which unintentionally becomes a private firm to continue to be taxed under subchapter C for a period of time. During that period, the firm could either regain public status, and thereby continue under subchapter C, or make permanent its private status. In the latter case, the normal consequences of a public-to-private change would then arise at the end of the period.

*c. Changing Tax Systems of Private Firms (SPBF to Default System or Vice-Versa).*—Under current law, the taxation of private firms which change tax systems is not very coherent. For example, an S corporation which converts to a partnership is treated as a taxable liquidation of the firm. On the other hand, a partnership can generally incorporate and elect to be taxed under subchapter S in a tax-free manner. Change from private subchapter C status to one of the other tax systems implicates the double tax features of subchapter C.

Under the proposal, all private firms are taxed as conduits, pursuant to either the SPBF or default systems. Thus, changing from one system to another, either by way of conversion or reorganization, could potentially be a tax-free transaction. That conclusion, however, must be tempered by the desire to protect the integrity of the rules of each system.

For example, the default conduit tax system, modeled after existing subchapter K, will likely have a number of structures in them that are intended to prevent abuse of that form. The SPBF structure does not include those provisions in order to keep its operational rules relatively simple and easy to work with. Thus, as previously described, the rules involving “hot assets” and special allocations are not included in the SPBF system. If a non-

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308. See Staff of the Joint Committee on Tax'n, 105th Cong., Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal 43 (Comm. Print 1977). The same proposal is included in the President's FY 1999 budget submission. President's Budget Proposals, FY 1999, 352 Table S-6 (Effect of Proposals on Receipts).

309. The public/private line under current law is set forth in § 7704(b) and the regulations thereunder.

SPBF private firm could be transformed into an SPBF with no tax consequences, it seems likely that the anti-abuse rules for the non-SPBF form could be avoided.

Similarly, consider the taxation of a firm changing from the SPBF system to the default conduit system. At first blush, this might seem to be the most benign of possible transactions because the firm is leaving a system with relatively few anti-abuse protections and entering one with many more. On the other hand, the default conduit system will likely contain various desirable tax features unavailable in the SPBF system. For example, the default system will likely permit inside basis adjustments not allowed by the SPBF system. A change from the SPBF to the non-SPBF system should not allow a firm to gain one of these tax advantages without being subject to an appropriate anti-abuse protection.

*Example 10.* A and B own an SPBF whose principal asset would generate ordinary income if sold. There is a sale of ownership interests from B to C. In the sale, B recognizes capital gain because the SPBF rules do not have a section 751-type rule. This result makes sense if C has more-or-less the same tax profile as B and steps into B's shoes vis-a-vis the unrealized ordinary income of the firm. C, however, is a nonresident alien and the sale therefore causes the firm to lose its SPBF status and to be taxed under the default conduit system. Under the default system, the firm makes a section 754 election which provides C with a special basis adjustment in the ordinary income asset of the firm to reflect the gain recognized by B on the sale. As a result, B's ordinary income liability is lost forever; it is not recognized by B on the sale nor will it be recognized by C in the future.

The precise tax consequences of private firms changing tax systems under the proposal are somewhat up in the air as long as all of the details of the SPBF and default conduit systems remain unsettled. However, the result under example 10 should not be permitted. In general, firms would be entitled to the benefits of the default system only if they are fully subject to the anti-abuse protections of that system.

*7. Transitional Considerations.*—This section will briefly discuss some transitional considerations to bridge the gap between current law and the proposals presented in this article.

To help explain the development of the concepts, this article has generally described the SPBF and default version of conduit taxation as brand-new operating rule systems. In fact, however, the SPBF system is very similar to existing subchapter S and the default system should be similar to

existing subchapter K. Thus, existing firms subject to either subchapter K or S should have little difficulty making the transition to the world presented by these proposals. Upon adoption of these proposals, the firms will simply be taxed under slightly amended versions of those subchapters.

Private firms currently taxed under subchapter C, however, face a significant transitional problem because that subchapter would no longer be available to such firms once the proposals are adopted. Moreover, the normal consequence of the conversion of a subchapter C firm to one taxed under a conduit tax system is a taxable liquidation of the former. It seems unlikely that forcing all existing private C corporations to liquidate in a taxable manner upon adoption of the proposals would either be appropriate from a policy standpoint or feasible politically.

The transitional alternatives to an immediate taxable liquidation of private C corporations run the gamut from (1) a permanent grandfather of all existing private C corporations; (2) a temporary grandfather period during which a liquidation must take place; (3) an immediate or deferred liquidation with resulting tax liabilities to be paid over an extended period of time, or with some reduction in the tax liability owed;<sup>310</sup> (4) a tax-free conversion to one of the conduit systems combined with rules such as sections 1374 and 1375 to preserve subchapter C gains; and (5) a tax-free conversion with no preservation of subchapter C gains. A number of factors, including political considerations, will help to decide which if any of these alternatives should be implemented.

## V. SUMMARY AND CONCLUSION

As a result of recent federal and state law developments, the taxation of private business firms is no longer rational. Existing law is built upon the premise that business organizational form and characteristics are significant for tax purposes. The recent developments, however, contradict that premise. Consequently, the entire scheme of taxing private businesses, including the current choices of subchapters C, K, and S for many private business firms, must be rethought.

This article suggests that in the future, all private firms should be taxed as conduits. Under conduit taxation, the firm is not taxed but the owners of the firm are. Although conduit taxation is flawed in important respects and is extremely complicated to implement, the alternative of taxing the firm and not the owners may not be any better. Further, an entity tax

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310. For example, any resulting gains might be taxable at a special low rate of tax, or some portion of the gains might be exempted from tax altogether. This option might be justified on the basis that most private C firms do not ever incur a full double tax on their income.

scheme would present greater transitional problems than widespread adoption of conduit taxation.

Because conduit taxation is so difficult, this article further suggests that it should be implemented in two versions. One version—a reformed subchapter K—should concentrate on providing as precisely correct conduit tax results as possible, even at the cost, if necessary, of some additional complication. The other version—a liberalized subchapter S—should focus on providing as administrable a set of conduit rules as possible with some concession, if necessary, to not achieving the correct outcome in all cases. Because the simplified conduit version would be elective to qualifying firms, careful consideration of the substantive tax outcomes under the two versions must be given to insure the continuing appeal of the simplified version.