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Benefits and Burdens of Subchapter S in a Check-the-Box World

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I. INTRODUCTION

The Treasury's issuance of the check-the-box regulations (CTB) in late 1996¹ has intensified debate about whether there should be a single federal income tax regime for all private business firms (PBFs), including passthrough entities, whose equity interests are not publicly traded.² This revived concern for parity in tax treatment among the various forms of passthrough entities arose because the CTB regulations generally allow a business entity with two or more owners to be taxed as a partnership for federal income tax purposes, regardless of its organizational structure and corporate-like characteristics under state law.³ Before the CTB regulations, unincorporated entities were required to maintain at least two noncorporate characteristics in order to avoid the double tax regime of Subchapter C.⁴

1. 61 Fed. Reg. 66,588 (1996), revising Regs. §§ 301.7701-1, -2, -3. The effective date of the regulations was January 1, 1997. See also Notice 95-14, 1995-1 C.B. 297. See Regs. §§ 301.7701-1(f), 301.7701-2(e), 301.7701-3(f)(1). For extended discussions of the regulations, see Mary A. McNulty, *Entity Classification: Final Check-the-Box Regulations Issued*, 9 J. S Corp. Tax'n 60 (1997); Roger F. Pillow et al., *Simplified Entity Classification Under the Final Check-the-Box Regulations*, 86 J. Tax'n 197 (1997); George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. Rev. 125 (1997).

2. A partial list of tax regimes for business entities includes C corporations, S corporations, partnerships (and all entities eligible to file as partnerships), real estate investment trusts (REITs), regulated investment companies (RICs), fixed investment trusts, financial asset securitization investment trusts (FASITs), and real estate mortgage investment conduits (REMICs). For discussion of the future of more exotic tax entities, see Willard B. Taylor, *Beyond Check-the-Box—Neglected Issues*, 75 Taxes 671 (1997).

3. Alternatively, a business entity may elect to be taxed as an association. This election is reminiscent of the former § 1361, which was enacted in 1958 to allow partnerships to elect to be taxed as corporations but was repealed in 1966, largely for lack of use. See Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, § 63, 72 Stat. 1606; Pub. L. No. 89-389, § 4(b)(1), 80 Stat. 111 (1966).

4. Under the former regulations, an unincorporated entity (other than a trust) was classified as an association, taxable as an association, if it exhibited three of the four corporate characteristics of (1) free transferability of interest, (2) continuity of life, (3) centralized management, and (4) limited liability. A trust was an association if it possessed two corporate characteristics: (1) beneficiaries acting as "associates" and (2) an objective to carry on business and divide the gains therefrom. See Regs. § 301.7701-2(a)(2) (1954) (before amendment in 1996); *Estate of Harry M. Bedell, Sr., Trust v. Commissioner*, 86 T.C. 1207, 1216-17 (1986), acq., 1987-2 C.B. 1. Under the CTB regulations, a trust is an "arrangement" whose purpose is to vest in trustees responsibility for the protection and conservation of the trust's assets for its beneficiaries. See Regs. § 301.7701-4(a). A "business trust," which otherwise may fall into the association abyss, may elect to be treated as a "business entity" under CTB regulations, allowing it to elect partnership status. See Regs. § 301.7701-4(b).

Revenue Ruling 88-76,⁵ which permitted limited liability companies (LLCs) to achieve partnership tax status under the former regulations, inspired state legislatures to jump on the LLC bandwagon by adopting LLC statutes and amending existing LLC statutes to conform to liberalized federal income and transfer tax interpretations. All states now have limited liability company laws,⁶ and many have added the limited liability partnership (LLP), which is a hybrid form of organizational structure, between the LLC and the limited partnership (LP),⁷ intended primarily for professional service organizations. The primary benefit of the LLP is that it insulates partner-members in professional service organizations from vicarious liability for malpractice errors and omissions.

Taxpayer efforts to clothe their entities with various corporate attributes without incurring association status for federal (and state) income tax purposes generated varying differences of opinion among practitioners, the Service, and the courts on whether particular unincorporated entities had crossed over the line.⁸ Especially troublesome for the Service was that organizations having the corporate characteristic of limited liability could achieve partnership tax status. Although it later conceded the point, the Treasury once proposed a bright line rule that unincorporated entities with limited liability under state law should be taxed as associations.⁹ The former

5. 1988-2 C.B. 360.

6. See, e.g., Del. Code Ann. tit. 6, §§ 18-101 to -1107 (1997); Fla. Stat. ch. 608.401 - 511 (1998); Tex. Rev. Civ. Stat. Ann. art. 1528n (West 1998); see also Unif. Lim. Lia. Co. Act, 6A U.L.A. 429-508 (1995).

7. See, e.g., Del. Code Ann. tit. 6, § 17-214 (1997); Fla. Stat. ch. 620.78 (1998); Tex. Rev. Civ. Stat. Ann. art. 6132b (West 1998).

8. See *Larson v. Commissioner*, 66 T.C. 159 (1976); *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); Rev. Proc. 95-10, 1995-1 C.B. 501; Rev. Proc. 94-46, 1994-2 C.B. 688; Rev. Proc. 92-88, 1992-2 C.B. 496; Rev. Proc. 89-12, 1989-1 C.B. 798. Before the development of the professional corporation, when more generous provisions could be made under qualified retirement plans for owner-employees of corporations than for self-employed persons (including partners), unincorporated entities engaged professional practices found it beneficial to be classified as associations for federal tax purposes. See *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954) (state law partnership imbued with sufficient corporate characteristics to adopt corporate qualified retirement plan). For a thorough analytical and historical overview of this area, see McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* 3-1 (1997).

9. In 1980, the Treasury proposed a regulation (Prop. Regs. § 301.7701-2(a)(2)) that would have treated an organization as an association if (1) the organization was not formed under a statute corresponding to the Uniform Limited Partnership Act and (2) no member of the organization was personally liable for the entity's obligations. See *Classification of Limited Liability Companies*, 45 Fed. Reg. 75,709 (1980) (proposed Nov. 17, 1980). LLCs and foreign entities having limited liability would have been trapped by the proposed regulations. See *id.* The proposal was withdrawn in 1983. See *Classification of Limited Liability Companies*, 48 Fed. Reg. 14,389 (1983) (withdrawn April 4, 1983). A formal concession of the issue was

regulations generally recognized partnership status for entities organized under state laws conforming to the Uniform Partnership Act and the Uniform Limited Partnership Act.¹⁰ Still, the economic stakes were quite high for investors in business and investment partnerships where the owners' underlying assumption of conduit treatment for federal income tax purposes might later be challenged by the Service. Substantial investments in joint ventures generally were not made without receiving a boilerplate-like legal opinion that the venture would "more likely than not" be taxed as a partnership for federal income tax purposes. For those who desired not to get too close to the edge of where partnership status ended and association status began without receiving a prior favorable ruling, the Service issued several safe-harbor ruling guidelines.¹¹

The CTB regulations have relegated the former regulations to historical significance, except for disputes for prior years.¹² Under the regulations, unincorporated entities, with the exception of certain ("per se") foreign entities required to be taxed as associations under Subchapter C,¹³ may have all four corporate characteristics and still be taxed as partnerships. An LLC may therefore achieve partnership classification for federal tax purposes, even if it possesses limited liability, centralized management, free transferability of interest, and continuity of life.¹⁴

Additional organizational and tax benefits flow from the regulation's introduction of the "tax nothing," which is the default status of an unincorpo-

made in Rev. Rul. 88-76, 1988-2 C.B. 360, which held that a Wyoming LLC could be a partnership for federal tax purposes, even if no member was personally liable for debts of the entity.

10. See Regs. § 301.7701-3(b)(1) (prior to amendment by T.D. 8697, 61 Fed. Reg. 66,584 (1996)).

11. See, e.g., Rev. Proc. 92-35, 1992-1 C.B. 790, amplified by Rev. Proc. 94-46, 1994-2 C.B. 688; Rev. Proc. 89-12, 1989-1 C.B. 798, supplemented by Rev. Proc. 92-33, 1992-1 C.B. 782, modified by Rev. Proc. 95-10, 1995-1 C.B. 501, and amplified by Rev. Proc. 91-13, 1991-1 C.B. 477 (checklist questionnaire); Rev. Proc. 86-12, 1986-1 C.B. 534.

12. The CTB regulations concede to taxpayers most lingering uncertainties over the pre-1997 classification of business entities. Unless a pre-1997 entity is a per se corporation under the CTB regulations, the classification that it claimed is "respected" for all periods before 1997 if (1) the entity had a reasonable basis (per § 6662) for the claim, (2) the entity and its members consistently maintained the claimed status for all periods, and (3) neither the entity nor any of its members received written notification before May 9, 1996, that the classification of the entity was under examination by the Service. See Regs. § 301.7701-3(f)(2). For pre-CTB foreign entities, see Regs. § 301.7701-2(d).

13. The regulations designate one type of entity in each country, considered equivalent to a corporation under the corporate laws of the U.S. states, as a per se corporation. Regs. § 301.7701-2(b)(8). Notice 98-35, 1998-27 I.R.B. 35 and Notice 98-11, 1998-6 I.R.B. 18, dealing with the tax status of foreign hybrid entities.

14. States using federal piggyback type models for income taxation will probably go along with the liberalized CTB regulations.

rated entity having only one owner. For tax purposes, such an entity is treated as a sole proprietorship if the owner is an individual or a division or branch if the owner is an entity. The entity exists for state law purposes but not for federal income tax purposes unless the owner elects association status.¹⁵

The advent of the CTB regulations, including the metaphysically wonderful tax nothing, has opened a new world of passthrough entities and multiple-tiered structures. Proponents of the CTB regulations contend that the federal tax law should permit various forms of entities under state law to be taxed under the same passthrough system by removing emphasis on formalisms inherent in the organizational and governance rules under state law.

In contrast with unincorporated entities, an incorporated PBF has the choice of being taxed in the double-tax world of Subchapter C or as a passthrough entity under Subchapter S. The S election is allowed only if various eligibility rules are met at both the entity and investor levels. Thus, the CTB regulations only indirectly benefit incorporated PBFs by permitting them to be members of LLCs or limited partnerships and to have wholly-owned LLC tax nothings.

The underlying premise of the CTB regulations is that state law differences in entity structure and governance should not be controlling for federal tax purposes. However, given the substantial differences between Subchapter K, the passthrough regime for unincorporated entities, and Subchapter S, the passthrough regime for incorporated entities, this premise is not fully realized.

Although the possibility of a single passthrough regime for all PBFs, whether incorporated or unincorporated, has obvious appeal, this vision would not be without its own problems. Consider the definitional problems that would plague business lawyers and estate planners without substantial tax backgrounds in working with incorporated PBFs taxed as partnerships. Under such a unified passthrough regime, preferred stock would be nothing more than a preferred partnership interest. For state law purposes, however, the corporation must have adequate surplus to make payments on the preferred stock. For tax purposes, the preferred stock might even receive a special allocation of income. Would the corporate and banking lawyers understand this new science? Or is it more likely to be a hapless exercise into schizophrenia?

Other follies seem destined to happen. A state law merger between two corporations, now partnerships for federal tax purposes, could be a taxable event, at least with respect to some partners.¹⁶ How are the entities to be treated for estate tax purposes, as corporations or as partnerships?¹⁷

15. See Regs. §§ 301.7701-2(a), 301.7701-3(a).

16. See Regs. § 1.708-1(b)(2).

17. For example, § 303, which does not apply to partnerships, would not apply to a corporation taxed as a partnership. Guidance is presently needed on the treatment of mergers

How would the principal and income act of a particular jurisdiction apply to distributions from tax nothings or from corporations that are partnerships and vice-versa.

Consider the estate planner's task and checklist of questions that she must ask in order to prudently plan for the demise of a wealthy client for whom she has prepared trust and will documents for years. Since the last set of will and trusts were executed several years ago, the LLC became the entity of choice, the CTB regulations were promulgated, and Congress has adopted the Treasury's recent proposals to treat a C to S or S to K conversion as a taxable liquidation. If one could eavesdrop on their estate planning conversation, which will occur sometime in the not too distant future, it might go like this.

Lawyer: Mr. Jones, tell me about your corporation.
Client: Well, I have a great business. I have had it for many years, and I am proud of my success. I know that business as well as anyone in the country. But, I am not sure if I can tell you, Lawyer, whether it is a corporation.
Lawyer: Well, Mr. Jones, why is it that you don't know whether you have a corporation? You've had the same business for over 40 years?
Client: Well, the tax people tell me that I am no longer a corporation but instead I am a partnership with my fellow shareholders who are partners.
Lawyer: You mean Abbott, Costello, and the young guy, Crystal?
Client: Yeah.
Lawyer: Well, Mr. Jones, is your paycheck drawn on a corporation?
Client: Yeah.
Lawyer: Do you file an annual corporation report with the state and hold directors and shareholders meetings?
Client: Yeah.
Lawyer: Do you still have that shareholders agreement we executed with Abbot, Costello, and Crystal years ago?
Client: Yeah, but you don't understand. It is not a corporation. It's a partnership or an LLC thing is what the tax guys are saying.
Lawyer: You mean your corporation was liquidated and is now a partnership or an LLC? Are you then a member or a manager of the LLC, or both?

involving single-member tax nothings owned by corporations. See Prop. Regs. § 301.7701-3(g); Tech. Adv. Mem. 98-22-0021 (Oct. 23, 1997).

- Client: You didn't listen to me, Lawyer. It's a corporation!!! It's not a partnership or an LLC. Only for tax purposes is it a partnership.
- Lawyer: I find this difficult to understand, you own stock, you get paid from a corporation, you have a shareholders' agreement, you have run the same business in your corporation for over 40 years, you haven't liquidated the corporation, but you are taxed as a partnership. Does that mean you have a capital account in your stock? I mean, if your capital account is negative, that might be a liability under state law.
- Client: Ignore state law dammit, that is what my tax advisers tell me. State law doesn't mean a thing.
- Lawyer: Let's go through this one more time, do you own stock in a corporation, or an interest in a partnership, Mr. Jones?
- Client: I'm leaving.

As reflected by this not too far fetched dialogue, a single world for taxing all PBFs as partnerships will erase long-standing accepted norms of corporate taxation. In its wake underlying state law will now dissolve and only the tax expert, sitting in a laboratory of magic and metaphysics will understand what is going on. Stock is not really stock, but instead is as a partnership interest; a partnership interest is not really a partnership interest but is to be treated as stock; a real entity for state law purposes is really a "nothing"; a corporation is really a partnership.

II. S CORPORATION VERSUS PARTNERSHIP COMPARISON AFTER THE CTB REGULATIONS

The past few years have witnessed the growth of the LLC as a preferred method for organizing and operating PBFs. Although LPS enjoy the same tax advantages as LLCs, the LLC permits members to be active in the organization's day-to-day affairs without risk of becoming liable as general partners. The LLC's state-law characteristics closely resemble those of the S corporation, but it is generally taxed as a partnership. A comparison of S corporations and LLCs is set forth below, although most of the tax comparisons are the same for limited partnerships and limited liability partnerships.

What this comparison reveals is that the combination of corporate state-law characteristics with conduit tax rules and the flexibility of Subchapter K makes the LLC the super-passthrough entity.¹⁸

18. Publicly traded partnerships are treated as corporations unless their income is predominately from passive sources. See IRC § 7704(a) & (c). A partnership falls within the scope of § 7704 if its interests are traded on an established securities market or are readily

A. State Law Differences

A corporation, C or S, is organized under a state statute pursuant to its corporate charter, which usually identifies the corporation's purpose, organizers or incorporators, place of residence, initial board of directors, and classes of stock. By-laws are adopted by the board of directors. Shareholders may enter into agreements concerning, for example, the voting of shares, participation on the board of directors, restrictions on the transferability of shares, super-majority voting requirements on some matters, and buy-sell arrangements in the event of death or other defined event. A corporation's owners are generally not liable for its debts, and the corporation has centralized management through its board of directors and exists perpetually until it is dissolved by vote of its shareholders. A wealth of jurisprudence and statutory authority delineates the duties and responsibilities of a corporation's officers, directors, and majority shareholders towards other shareholders. Since the corporation is recognized in all jurisdictions, its limited liability feature is universally accepted, subject to limited "piercing the corporate veil" theory for alter ego scenarios.

An LLC is also a creature of state law and borrows from both the centralized management model of the corporation and the aggregate or agency model of the partnership. Although the states' LLC laws vary from each other, especially on default provisions, the legislative trend is to permit freedom of contract among LLC members on fundamental management and ownership issues. As a result, the LLC, through a comprehensive member agreement, can blend the amounts of fiduciary responsibility, management, and voting rules desired by the owners.¹⁹ As the new entity kid on the block, however, there is not yet a body of jurisprudence that can be drawn upon to guide LLC members as to their rights and duties. Accordingly, the members' agreement and the rules governing the interpretation and enforcement of contracts has paramount importance.

Because the LLC allows the same type of ownership and management structure available to shareholders in a close corporation and limited liability for entity obligations, state law should be considered a neutral factor in comparing multiple member LLCs to S corporations. The efficacy of a single member LLC for conducting business operations in multiple jurisdictions is

tradeable on a secondary market or the equivalent of a secondary market. See IRC § 7704(b); Regs. §§ 1.7704-1(a)(1), (b). Some passive publicly-traded partnerships still qualify for passthrough treatment. See IRC § 7704(c).

19. See Unif. Lim. Lia. Co. Act § 103, 6A U.L.A. 434-35 (1995) (allowing members to internally regulate such matters using an operating agreement).

still open to debate. Although recognized in all but seven jurisdictions,²⁰ the single member LLC may afford its owner less protection from unlimited liability than an S corporation, which generally ensures limited liability.²¹

B. Eligibility Limitations

1. *Number of Equity Participants.*—There is no limitation on the number of investors who can participate in a partnership or in an LLC taxable as a partnership, although a public market for interests in the entity will cause it to be a publicly traded partnership, taxable under §7704 as an association. Under CTB, a single member LLC is usually ignored as a separate entity for federal tax purposes unless an election is made to have the entity taxed as a corporation.²² Presently, all but seven states permit single member LLCs.²³ A single member LLC, organized in one of the states authorizing single-member LLCs, that does business in states not allowing single member LLCs must grapple with critical state law conflicts of law questions as to whether the other states will recognize the limited liability of the foreign LLC's single member.

Subchapter S has always restricted the number of shareholders.²⁴ Starting off by limiting S corporations to not more than 10 shareholders, Congress gradually increased the maximum number to the present 75.²⁵ Spouses and their estates are considered to be one shareholder, regardless of which spouse owns the stock and even if they are both shareholders,²⁶ but

20. Bruce P. Ely & Christopher R. Grissom, *The LLC/LLP Scorecard*, 81 *Tax Notes* 1005 (Nov. 23, 1998) (California, District of Columbia, Idaho, Massachusetts, Montana, Pennsylvania and Tennessee either do not recognize or do not clearly recognize single member LLCs).

21. However, the separate identity and formalities of the corporation must be observed by the sole shareholder to avoid a nominee or "pierce the corporate veil" attack. See also James D. Cox & Brian W. Woods, *Piercing the Veil in Limited Liability Companies*, 4 *J. Lim. Lia. Co.* 24 (1997).

22. See Regs. § 301.7701-3(b)(1); Gen. Couns. Mem. 39,395 (Aug. 5, 1985) (four-part test under prior regulations applied to single member entity); Francis J. Wirth & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, 59 *Tax Notes* 1829 (June 28, 1993).

23. See Ely & Grissom, *supra* note 20, at 1005.

24. Until recently, use of multiple S corporations to engage in a single business as partners, in order to circumvent the shareholder number limitation, jeopardized each S corporation's election. Rev. Rul. 77-220, 1977-1 C.B. 263, revoked by Rev. Rul. 94-43, 1994-2 C.B. 198. See also Rev. Rul. 78-390, 1978-2 C.B. 220 (more than maximum number of shareholders receiving distributions during year as a result of a stock transfer did not result in termination).

25. See IRC § 1361(b)(1)(A) (ceiling is 75 shareholders for taxable years beginning after 1986).

26. IRC § 1361(c)(1).

there is no other rule for attributing stock among family members or entities.²⁷ The increases in the shareholder ceiling were intended to facilitate multi-generational ownership of S corporations, an important factor in estate planning for shareholders. However, the number limitation has never been problematic for most S corporations because the overwhelming majority of them have five or fewer shareholders.²⁸

2. *Eligible Equity Participants.*—Although any individual or entity, whether domestic or foreign, including a trust, estate, corporation, LLC, LLP, or partnership, may be a member of an LLC, S corporations continue to be subject to rigid shareholder eligibility limitations. For example, nonresident aliens are not permitted to own S stock, even though tax compliance concerns could be greatly reduced by a withholding regime like the one presently in place for partnerships with foreign partners.²⁹ Similarly, a corporation may not own stock in an S corporation,³⁰ although a qualified subchapter S subsidiary (QSUB) rule, discussed more fully below, is an important exception to this prohibition. Partnerships, including LLCs and LLLPs, are also impermissible shareholders of an S corporation.³¹ The same holds true for trusts that are not grantor trusts, qualified Subchapter S trusts (QSSS), or electing small business trusts (ESBT). Given the long-standing advantages for entities taxed as partnerships and the CTB regulations' scrapping of state law characteristics as determinative of entity tax status, the continued limits on S corporations are hard to justify.

An eligibility question generated by the CTB provisions is whether a single member LLC can be an S shareholder. Since its tax status is that of a "tax nothing," stock held by such an LLC should be considered owned by the LLC's owner, much in the same way as a grantor trust is ignored and the beneficial owner is treated as shareholder with respect to stock held by a nominee.³² The Service has also ruled that a corporation's S election did not terminate when its stock was held by a nonresident alien as custodian for a

27. See Rev. Rul. 59-187, 1959-1 C.B. 224.

28. See Susan C. Nelson, *S Corporations: The Record of Growth After Tax Reform*, 5 J. S Corp. Tax'n 138 (1993).

29. See IRC § 1446.

30. See IRC § 1361(b)(1)(B).

31. See *Kates v. Commissioner*, 27 T.C. Memo (CCH) 1423, T.C. Memo (P-H) ¶ 68,264 (1968). But see *Guzowski v. Commissioner*, 26 T.C. Memo (CCH) 666, T.C. Memo (P-H) ¶ 67,145 (1967) (S stock owned by partners, not partnership, because partnership found to have dissolved).

32. See *Pahl v. Commissioner*, 82 A.F.T.R. 2d 98-5418 (9th Cir. 1998); *Ozier v. Commissioner*, 36 T.C. Memo (CCH) 236, T.C. Memo (P-H) ¶ 77,053 (1977), *aff'd*, 600 F.2d 594 (6th Cir. 1979). See also *Priv. Ltr. Rul. 90-10-042* (Dec. 11, 1989); *Priv. Ltr. Rul. 89-34-020* (May 24, 1989) (momentary ownership of S stock by partnership ignored).

U.S. citizen under a uniform gift to minor's act.³³ Thus, if the owner of the LLC "tax nothing" is an eligible shareholder, stock owned by the LLC should be considered held by an eligible shareholder, notwithstanding the LLC's separate identity under state law.³⁴

3. *Limitations on Use of Debt and Equity.*—The most serious disadvantage faced by S corporations and their shareholders, relative to unincorporated businesses taxed under Subchapter K, is a rule precluding an S corporation from having more than one class of stock.³⁵ Thus, an S corporation cannot provide a liquidation or distribution preference to any shareholder. Even buy-sell agreements and similar arrangements must be sanitized to avoid a prohibited second class of stock. A buy-sell agreement, agreement to restrict the transferability of stock, or cross purchase and redemption agreement creates a prohibited second class of stock if a principal purpose of the agreement is to circumvent the one class requirement and the agreement establishes a redemption or purchase price that, at the time the agreement is made, is significantly below or in excess of the stock's fair market value.³⁶ An S corporation can only issue or enter into the following types of securities or arrangements without placing its S status at indeterminable risk: (1) issue "straight debt";³⁷ (2) issue nonvoting (in addition to voting) common stock;³⁸ (3) enter into equity-type arrangements not resulting in the issuance of stock, including options (other than "in the money" options), phantom stock, and stock appreciation rights;³⁹ or (4) enter into a joint venture or other business arrangement with persons otherwise desirous of owing stock in the S corporation directly.

33. See Rev. Rul. 71-287, 1971-2 C.B. 317.

34. See Regs. § 1.1362-6(b)(3)(i); *Hook v. Commissioner*, 58 T.C. 267 (1972); *Kean v. Commissioner*, 51 T.C. 337 (1968), aff'd 469 F.2d 1183 (9th Cir. 1972).

35. See IRC § 1361(b)(1)(D); Regs. § 1.1361-1(f).

36. See Regs. § 1.1361-1(f)(2)(iii). Generally, agreements to redeem or purchase stock upon the death, divorce, disability or termination of employment are disregarded under the one-class-of-stock analysis. See Regs. § 1.1361-1(f)(2)(iii)(B).

37. Straight debt is a written and unconditional obligation to pay a sum certain in money with interest rate and payment dates not contingent on the borrower's profits, discretion, or other factors and with no right to convert, directly or indirectly, into stock. See IRC § 1361(c)(5). The holder of the debt must be an eligible shareholder except that after 1996, a entity or person actively and regularly engaged in the business of lending money may hold straight debt under the safe harbor. See IRC § 1361(c)(5)(B)(iii).

38. See IRC § 1361(c)(4).

39. See Regs. § 1.1361-1(b)(4) (permissible incentive compensation arrangements); Priv. Ltr. Rul. 94-06-017 (Nov. 15, 1993) (stock appreciation rights did not violate the one-class-of-stock requirement); Priv. Ltr. Rul. 90-40-035 (July 6, 1990) (phantom stock plan did not result in second class of stock). As to restricted stock under § 83, see Regs. § 1.1361-1(b)(3).

Use of a tax partnership, which may now have all four of the corporate characteristics identified in the former regulations, facilitates the issuance of various types of equity interests, accommodating the interests of the parties without sacrificing passthrough status.⁴⁰ LLCs and partnerships may, without jeopardizing their tax status as passthrough entities, issue multiple classes of equity interests, create distribution and liquidation preferences and priorities, make special allocations of tax items within boundaries permitted by section 704, and issue equity-flavored debt, which may include a debt-to-equity conversion privilege.

4. *Use of Multi-Tiered Structures or Affiliates.*—Except as barred by state regulations of various professions, a partnership, LLC, or LLP can itself be a partner or member of another partnership, LLC, or LLP. Multi-tiered structures of unincorporated passthrough entities are quite common and facilitate combinations of business and investment pools and assets. Even within a single set or group of owners, use of subsidiary LLCs, including single member LLCs, may achieve a desired segregation of business assets and creditors. It may also provide state tax or licensing benefits.

Until 1996, S corporations were greatly disadvantaged in this respect because former section 1361(b)(2)(A) prohibited an S corporation from being a member of an “affiliated group,” which, under section 1504, generally required that the corporation own at least 80%, by vote and value, of the stock of another corporation.⁴¹ This prohibition could be avoided by intentionally flunking one of the two 80% tests in testing for affiliation. Since no attribution rule applies for this purpose, the S corporation’s shareholders could hold the remaining stock of the subsidiary, thereby achieving a de facto affiliation. In its plain vanilla form, issuance of 21% of the stock of an affiliate to one or more shareholders of the S corporation would preserve the parent corporation’s S status. If the cost to the shareholders of buying more than 20% of the subsidiary’s stock was too steep, much of the S corporation’s investment could be represented by nonvoting stock, and the shareholders could acquire, at a much reduced cost, voting stock sufficient to flunk the 80% test.

S corporations were permitted to “affiliate” with another corporation in order to engage in a tax-free reorganization or division, but only

40. But see Regs. § 1.1361-1(f) (generally prohibiting a corporation with more than one class of stock from qualifying as an S corporation).

41. Limited statutory relief was provided for an “inactive” subsidiary. IRC § 1361(c)(6) (before amendment in 1996). Before 1983, an S corporation could control an “excluded” corporation under § 1504(b), but this exception was repealed in 1982, subject to grandfathering relief, in the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 6(c)(1), 69 Stat. 1697 (codified at IRC § 1361(c)(1) (1982)), reprinted in *Internal Revenue Acts, Text and Legislative History*, at 273, 301 (1982).

momentarily.⁴² The Service extended this exception to acquisitions of the stock of a target corporation followed by a liquidation within 30 days,⁴³ but the Tax Court cast doubt on whether there was the necessary statutory foundation for a 30-day grace period.⁴⁴

After the 1996 repeal of section 1361(b)(2)(A), an S corporation may own any percentage of the stock of a C corporation. A C subsidiary may also file a consolidated return with its C corporation affiliates, although the S corporation parent may not join in this filing. Dividends to the parent S corporation are ineligible for a dividends received deduction, and other intercompany transactions are further excluded from application of the consolidated return rules.⁴⁵

5. *Qualified Subchapter S Subsidiaries (QSUBs).*—A far greater benefit introduced in 1996 is that an S corporation may now own all of the outstanding stock of a subsidiary and achieve passthrough treatment at the subsidiary level if the parent S corporation elects to treat the subsidiary as a division.⁴⁶ This rule, which is effective for taxable years beginning after 1996, is the most important amendment to Subchapter S contained in that year's legislation.

A qualified subchapter S subsidiary (QSUB) is a domestic corporation, otherwise eligible to make an S election, (1) all of the issued and outstanding stock of which is owned by an S corporation and (2) which the S corporation elects to treat as a QSUB.⁴⁷ In temporary guidance, the Service announced that QSUB elections, which must be made subsidiary by subsidiary, are to be made on Form 966 with special notation.⁴⁸ The Blue Book explanation allows for tiers of QSUBs.⁴⁹ Once a break in the QSUB

42. See Rev. Rul. 72-320, 1972-1 C.B. 270 (reorganization momentary affiliation disregarded); Gen. Couns. Mem. 39,768 (Dec. 1, 1988).

43. See Rev. Rul. 73-496, 1973-2 C.B. 312.

44. See *Haley Brothers Construction Corp. v. Commissioner*, 87 T.C. 498 (1986); see also Jerald D. August, *Acquisitions Involving S Corporations*, in *New York University—Proceedings of the Fifty-Second Institute on Federal Taxation* § 3-1 (1994); Samuel P. Starr, *S Corporations: Operations*, 371 *Tax Mgmt.* (BNA) 105-127.

45. The inapplicability of the intercompany (deferred or matching) transaction rules requires that attention be given to intercompany sales or transfers between an S corporation and a C corporation in which the S corporation owns 50% or more of its stock. See IRC §§ 267(a)(1); 267(a)(2); 267(b)(3); 267(f); 1239; 453(e).

46. See IRC § 1361(b)(3).

47. See IRC § 1361(b)(3)(B). A QSUB may not be a financial institution described in § 585, insurance company subject to Subchapter L, possessions corporation, DISC, or former DISC. See IRC § 1361(b)(2).

48. See Notice 97-4, 1997-1 C.B. 351.

49. Staff of Joint Comm. on Tax'n, 104th Cong., 2d Sess., *General Explanation of Tax Legislation Enacted by the 104th Congress* 120 nn.120-21 (Comm. Print 1996).

chain occurs by the interposition of a C corporation, the QSUB election may not be made with respect to any lower-tier subsidiary, but lower-tier corporations may join in a consolidated tax return.⁵⁰ In a manner resembling the effect of a single member LLC, a QSUB is treated as a division of the S corporation, and its separate existence is ignored during the QSUB period. The QSUB therefore does not maintain a separate accumulated adjustments account or collect earnings and profits. Instead, the computation of taxable income or loss, accumulated adjustments account, built-in gains subject to entity level tax, passive investment income, characterization of distributions, and other tax accounting is determined on an aggregate basis by the parent S corporation.

a. *Deemed Liquidation.*—If the subsidiary existed before the first year for which the QSUB election is made, the election is treated as a liquidation of a wholly owned subsidiary into its electing S corporation parent.⁵¹ Generally, under sections 337 and 332, no gain or loss is recognized by the liquidating subsidiary or the parent. Under sections 381 and 334(b), the S corporation parent inherits the QSUB's tax attributes and the adjusted basis of its assets. If the subsidiary was a C corporation, the deemed liquidation causes the parent S corporation to become subject to the built-in gains tax under section 1374 with respect to the QSUB's assets. If, as a C corporation, the QSUB used the LIFO method of inventory accounting, the special four-year recapture rule of section 1363(d) comes into play. Post-QSUB election problems may also arise from inheriting the C earnings and profits, which may affect the S corporation's post-QSUB distributions to its shareholders.⁵² If there is a significant amount of passive investment income, the carryover of earnings and profits may also result in an entity level tax under section 1375 and eventually pose a termination risk under section 1362(d)(3).

Aside from the tax attribute issues generated by a deemed liquidation, the most immediate drawback to the QSUB election may be a disappearing basis problem for a purchased subsidiary. Assume an S corporation purchases all of the stock of a target C corporation for \$2,000x and does not make a section 338 election; the target's basis for its assets is \$500x. By purchasing all of the target's stock and making the QSUB election (or, alternatively, by immediately liquidating the target into the purchaser), \$1,500x of basis—the excess of the \$2,000x paid by the parent for the subsidiary stock over the target's basis for its assets—disappears because, under section 334(b), the

50. See IRC § 856(i). For an analogy, see Priv. Ltr. Rul. 95-27-020 (Apr. 6, 1995) (REIT lower tier subsidiaries).

51. See Staff of Joint Comm. on Tax'n, *supra* note 49, at 120 n.121.

52. See IRC § 1368(c) (distributions by S corporations with earnings and profits).

parent succeeds to the subsidiary's basis for its assets. Gain equal to the lost basis may be recognized by the S corporation as built-in gain under section 1374 if the QSUB sells its assets within 10 years.

Finally, the Service has been heard to be rattling its saber that it will apply the *Bausch & Lomb* doctrine to a contribution of more than 20% of the stock of a subsidiary to an S corporation in order to make a the subsidiary eligible for a QSUB election.⁵³ This fear was confirmed by proposed regulations issued this year.⁵⁴

b. *Conversion of Consolidated Group Into QSUB Group.*—If there is 100% ownership of each member of a consolidated group, and the shareholders of the parent C corporation are permissible shareholders, the QSUB rules make it possible to convert the entire group to a Subchapter S regime. As previously mentioned, such a conversion would result in the application of the built-in gains tax and LIFO recapture and other C to S conversion issues. Before 1996, the group could have been converted from C to S only by merging or liquidating all of the subsidiaries into the parent, which may have caused an undesirable shift in risk to the parent since all subsidiary debt would effectively be assumed. With the new QSUB rule, the conversion to Subchapter S can be accomplished without changing the group's structure, thereby maintaining desired asset and liability segregation.

A consolidated group has a tax history, including intercompany transactions that have been deferred or nonaccelerated, and, in appropriate instances, a group must track the parent company's obligation of a subsidiary's losses in excess of the parent's investment in the subsidiary ("excess loss account" or ELA). A question arising in converting a consolidated group to a QSUB regime is the effects of the conversion on intercompany accounts and ELAs. As to deferred or nonaccelerated intercompany gain, since the benefits of consolidated reporting are revoked in favor of a single tax system under Subchapter S, the Service may feel that it is appropriate to require a complete catch-up, triggering deferred gain on intercompany transactions upon a QSUB conversion. On the other hand, the long-standing policy is that a C to S conversion is not a realization event. Since there is a carryover of adjusted basis to the S corporation parent, there is arguably no need to impose tax.⁵⁵

53. *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959).

54. See Prop. Regs. §§ 1.1361-2 to -5; Jerald D. August et al., *A Planning Guide to the Proposed Regulations on Qualified Subchapter S Subsidiaries*, 10 J. S Corp. Tax'n 171 (1999); Jerald D. August & Jeffrey L. Rubinger, *Proposed Regulations Dealing with Qualified S Corporation Subsidiaries Issued by the Service*, 10 J. S Corp. Tax'n 109 (1998).

55. Under regulations in effect for taxable years commencing prior to July 12, 1995, deferred intercompany gain generally was not recognized in a § 332 liquidation. See Regs.

The issue with ELA recapture is perhaps easier to resolve favorably than the intercompany transaction issue since the consolidated return regulations do not impose ELA recapture on a section 332 liquidation.⁵⁶ However, confirmation of this result is needed because an argument may be made that given the QSUB election, the affiliated group will not be in existence at the time of the deemed liquidation that would trigger ELA recapture. Perhaps using a preemptive strategy of effectuating a state law merger of the subsidiary into a single member LLC avoids the issue even during this wait-for-guidance period. If the QSUB or chain of QSUBs generating the ELA is insolvent, a section 332 triggers recapture.⁵⁷

c. Termination of QSUB Election: Deemed Section 351 Transfer.—QSUB status may be terminated by revocation or by a transfer of a single share of subsidiary stock to a shareholder or third party. Following the termination, the QSUB is treated as a new corporation that acquires all of its assets and assumes all of its liabilities from the S corporation parent in exchange for its stock in a deemed section 351 transaction.⁵⁸ The former QSUB is prohibited from re-electing S status or QSUB status for 5 years unless the Service grants permission.⁵⁹

Section 351 treatment may seem innocent, especially since the statute provides that the deemed transfer occurs “immediately before such [QSUB] cessation.” Since a section 351 exchange is generally nontaxable where there is a single shareholder who transfers all of the assets in exchange for all of the issuing corporation’s stock, only section 357(c), which applies if the transferred liabilities exceed the basis of the transferred assets, should pose a trap for the unwary. However, the Service may take the position that the 80% control test is violated if more than 20% of the QSUB’s stock is transferred out, either by a distribution of subsidiary stock to shareholders or sale to third party.⁶⁰ This would cause all of the former QSUB’s asset value in

§ 1.1502-13(a)(1)(ii) (withdrawn by T.D. 8597, 60 Fed. Reg. 36,671 (1995)). The result is otherwise under the new (accelerated and matching) intercompany rules. See Regs. § 1.1502-13(f)(5)(i).

56. See Regs. § 1.1502-19(a), (b).

57. See Regs. § 1.1502-19; *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977). Compare *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967); Rev. Rul. 68-602, 1968-2 C.B. 135.

58. IRC § 1361(b)(3)(C).

59. See IRC § 1361(b)(3)(D); see generally August et al., *supra* note 54.

60. Compare *American Bantam Car. Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949) with *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (binding obligation to sell 50% of stock to underwriter broke 80% control requirement under § 351). See also *Bausch & Lomb*, *supra* note 53. Recently issued proposed regulations confirm the Service’s hard line position. See August & Rubinger, *supra* note 54.

excess of adjusted basis to be fully taxable to the transferor S corporation which gain would passthrough to its shareholders. Depreciable capital gain property deemed transferred to the former QSUB would generate ordinary income.

6. *Tax Rate Comparison.*—The present maximum marginal income tax rate of 39.6% on an LLC member who is an individual is the same as that for an S shareholder. In contrast, the maximum rate of federal income tax on a C corporation is 34% (35% for personal service corporations and corporations with taxable income exceeding \$10,000,000). S shareholders, however, enjoy a slight advantage in the employment tax area. The combination of FICA and hospital insurance taxes for employees, including S employee/shareholders, is 15.3% on the first \$61,200 on wages, but the hospital insurance tax of 2.9 percent also applies to compensation in excess of this dollar ceiling.⁶¹ By setting a reasonable salary, in this context one that is not unreasonably too low, an S shareholder can avoid these employment taxes on the shareholder's share of the corporation's income after salaries.

Under section 1402(a), an individual partner's net earnings from self-employment, which is also taxed at a rate of 15.3%, includes the partner's entire distributive share of partnership income unless the individual is a limited partner.⁶² It is not possible to restrict the amount subject to self-employment taxes to amounts designated as wages. A limited partner's distributive share of income (or loss) is exempt from self-employment tax, but a guaranteed payment to a limited partner for services is within the self-employment tax base.

Under recently revised proposed regulations,⁶³ an individual investor in a passthrough entity, including an LLC, will be considered a limited partner for self-employment tax purposes unless the individual (1) is

61. Cf. IRC §§ 3101(a), (b); 3111(a), (b). But see Rev. Rul. 59-221, 1959-1 C.B. 225 (shareholders in S corporations not subject to self-employment tax on share of undistributed income).

62. Exceptions are also provided for rental income, interest and dividends, and capital gains and losses. IRC §§ 1402(a)(1), (2), (3).

63. REG-209824-96, 62 Fed. Reg. 1,702 (Jan. 13, 1997), which superseded regulations proposed in 1995. 1995-1 C.B. 853. The revised regulations are effective for the first taxable year of the member or partner beginning after they are published as final regulations. See *id.* Under the earlier proposed regulations, an individual member of an LLC was treated as a limited partner for self-employment tax purposes if the member (1) did not have authority to make management decisions and (2) would have been a limited partner under the state in which the LLC was organized had the LLC instead been formed as a limited partnership. See also Priv. Ltr. Ruls. 95-25-058 (June 23, 1995), 94-45-024 (Nov. 10, 1994), 94-23-018 (June 10, 1994).

personally liable for entity debts by reason of being a partner or member,(2) has authority to contract on behalf of the entity under state law or the governing instrument, or (3) participates for more than 500 hours during the taxable year in the entity's trade or business.⁶⁴ The exclusion for limited partners could not apply to certain "service" members or partners.⁶⁵ The proposed regulations acknowledge, somewhat favorably, that an individual may bifurcate his or her distributive share of LLC (or partnership) income between an "active" and "passive" class for self-employment tax purposes.⁶⁶

7. Certainty of Tax Status.—Despite recent efforts to reform Subchapter S, its tax status as a passthrough entity must still be perfected by affirmative act of its shareholders and then carefully monitored and maintained throughout its existence. Once lost, an S corporation cannot re-elect S status for five years unless the termination was inadvertent or the Service permits an early re-election. For most re-elections, a substantial cost is incurred in the form of the built-in gains tax under section 1374 for ten years after the re-election. This corporate-level tax generally applies to realizations during the 10-year period of gains accrued before the re-election, including gains accrued during S years. Although it applies whether an early re-election is allowed or the five-year sentence is imposed, accrued gains tend to be larger if the intervening C period is longer.

In contrast, after CTB, a domestic unincorporated business entity with two or more owners is a partnership for federal tax purposes unless it elects to be an association,⁶⁷ and a single member LLC is disregarded for tax purposes unless it elects association treatment.⁶⁸ The tax status of an LLC as a passthrough entity is thus simple to establish and maintain. Again, the advantage goes to the LLC.

8. Formation Issues.—Section 351 provides tax free treatment for transfers of property to a corporation if the transferors control the corporation

64. Prop. Regs. § 1.1402(a)-2(h)(2). The reference to personal liability would put the day-to-day participation or control in partnership affairs test of state partnership law into the equation. See Rev. Unif. Limited Partnership Act, § 303 (1976). A partner or member participating in the partnership's business for more than 500 hours during the year would be limited partners if other persons holding "substantial continuing interest[s]" in the same class of partnership interests do not participate for as many as 500 hours. Prop. Regs. § 1.1402(a)-2(h)(4).

65. The excluded persons are "service partners" of an entity "substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting." Prop. Regs. § 1.1402(a)-2(h)(5).

66. See Prop. Regs. § 1.1402(a)-2(h)(3).

67. See Regs. §§ 301.7701-2(c)(1), 301.7701-3(b)(1)(i).

68. See Regs. §§ 301.7701-2(c)(2), 301.7701-3(b)(1)(ii).

immediately thereafter.⁶⁹ Section 368(c) defines control for this purpose as ownership of at least 80% of the stock, by vote and value. If appreciated property is transferred to a controlled corporation in exchange for stock and other consideration (e.g., cash or debt instruments of the corporation), gain or loss is recognized to the extent of the fair market value of the other consideration (boot). Also, if the adjusted basis of the transferred property is less than the debt assumed or taken subject to by the corporation, the excess is taxable gain.⁷⁰ The transferring shareholder recaptures depreciation on the transferred assets only to the extent that gain is recognized on the transfer of the depreciated assets.⁷¹ The transferee corporation generally receives the contributed assets with a carryover basis and inherits the transferor's holding period for the property.⁷² The shareholder's basis for the stock received is the adjusted basis of the property transferred, less the value of boot received and liabilities assumed, plus any gain recognized.⁷³

In contrast, under section 721, no gain or loss is recognized on a transfer of property to a partnership in exchange for a partnership interest, regardless of the transferor's proportionate interest in the partnership. If a contributing partner receives consideration in addition to the partnership interest, this consideration is treated as distributed by the partnership to the partner. Generally, a partner recognizes gain on a distribution only to the extent that the cash distributed exceeds the adjusted basis of the partner's partnership interest, which initially equals the adjusted basis of the contributed property.⁷⁴ The partnership's assumption of a partner's liability or taking of contributed property subject to a liability is treated as a cash distribution to the partner equal to the amount by which this liability exceeds the partner's share of the partnership's liabilities, including the liability assumed or taken subject to.⁷⁵ A partner who contributes property encumbered by debt exceeding the property's basis thus may, but is not certain to, recognize gain on the contribution. Gain may be recognized, for example, where an LLC member's contribution for her LLC interest consists of real property that has been depreciated while the member held it at a rate faster than the member paid down principal on a mortgage on the property.

69. Contributions of property by a shareholder to a corporation not in exchange for stock also are generally tax-free. See IRC § 118.

70. See IRC § 357(c). But see *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989); IRC § 357(b) (tax avoidance purpose rule). Transfers to investment corporations and partnerships are usually taxable. See IRC § 721(b); Regs. § 1.351-1(c)(5).

71. See IRC §§ 1245(b)(3), 1250(d)(3).

72. See IRC §§ 362(a), 1223(2).

73. See IRC § 358(a).

74. See IRC §§ 722, 731(a)(1).

75. See IRC § 752; Regs. § 1.752-3.

Despite the seeming competitive advantage of section 721 over section 351, there are several potential advantages to S corporations with respect to contributions of property. First, the character of property held by a corporation is usually determined by reference to the corporation's purpose in acquiring and holding the property. Thus, if a shareholder contributes inventory or dealer property to an S corporation, the dealer or inventory taint does not automatically remain.⁷⁶ Assume a real estate developer, who has held a tract of land for development while it has substantially appreciated, contributes it to an S corporation that she organizes with other investors, and the corporation constructs an apartment or office building on the property. Gain on a subsequent sale of the property may be section 1231 gain, even though it would have been ordinary income if the developer had constructed the building.

A second Subchapter S benefit from the same scenario is that the developer's pre-contribution built-in gain is not allocable to him. Instead, the gain, like all other items of the corporation's income, is allocated among the shareholders in proportion to their stock ownership in the year of sale.⁷⁷

Contributions of capital assets may bring opposite results. Assume an investor contributes loss property held for investment to an S corporation. The investor would have had capital loss on a sale of the property before the contribution. If the S corporation develops the property for sale to customers, loss on its sale of the property will be ordinary. As with the gain, the investor's precontribution built-in loss will, when realized by the corporation, be allocated among all shareholders in proportion to their daily stock ownership during the year of the sale.

Such changes in character and shifts in gain or loss are less likely to occur when property is transferred to a partnership. In contrast to the S corporation approach, which looks to the entity's purpose in holding an asset contributed by a shareholder, section 724 often fixes asset characterization, providing that contributed property that was an unrealized receivable, inventory, or capital loss property in the contributing partner's hands retains this character in the hands of the partnership for five years after the contribution. Appreciated capital gain property, however, is not subject to section 724 and can be immediately recharacterized as a noncapital asset by virtue of partnership activities.

Also, under section 704(c), precontribution built-in gain or loss must be allocated back to the contributing partner when it is realized by the partnership. The partner may be required to recognize precontribution gain

76. This is not to suggest that the Service would not raise a challenge if it perceived an abuse. See *Bouno v. Commissioner*, 74 T.C. 187 (1980), acq. 1981-1 C.B. 1; see also IRC § 341(e).

77. See IRC § 1366(a).

before the partnership realizes it if the partner receives a large distribution from the partnership within five years after the contribution.⁷⁸ The partner must also recognize precontribution gain or loss if the contributed property is distributed to another partner within seven years after the contribution.⁷⁹ Moreover, if a contribution of property is followed shortly (e.g., within 2 years) by a distribution to the contributing partner, the contribution may be recharacterized as a sale.⁸⁰ Subchapter S has no analogues, except that a corporation recognizes gain under section 311(b) on any distribution of appreciated property.

Since a single member LLC is disregarded for federal tax purposes unless it elects to be taxed as an association, gains and losses realized by the entity are taxed to the owner in precisely the way in which they would have been taxed if the entity had not been organized.

9. *Services Provided in Exchange For Equity Interests.*—If a member of an LLC receives a capital interest in exchange for services, the transfer falls outside of section 721, and the value of the interest is a guaranteed payment, includable in the recipient's gross income.⁸¹ A capital interest for services may also have tax consequences for the other members.⁸² Efforts are frequently made, sometimes successfully, to achieve tax-free treatment under section 721 by claiming that the service provider contributed "property."⁸³ If a services member receives only an interest in future profits, the Service's position is that receipt of the interest is not taxable unless there is a certain and predictable stream of income from LLC assets or the recipient member disposes of the profits interest within two years.⁸⁴

S stock received for services is taxable to the recipient if the stock is either nonforfeitable or transferable. A corresponding deduction is allowed to

78. On such a distribution, the contributing partner must recognize as gain the lesser of (1) the excess of the distributed property's fair market value over the adjusted basis of the partner's partnership interest or (2) the previously unrealized precontribution gain. See IRC § 737(a).

79. See IRC § 704(c)(1)(B).

80. See IRC § 707(a)(2)(B); Regs. § 1.707-3(c). See also Regs. § 1.731-1(c)(3); *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980).

81. See IRC §§ 83(a), 707(c); Regs. § 1.721-1(b)(2).

82. Regs. §§ 1.721-1(b)(1); 1.83-6(b).

83. *United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984); *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964); *Ungar v. Commissioner*, 22 T.C.M. (CCH) 766 T.C. Memo (P-H) ¶ 63,159 (1963); cf. Rev. Rul. 78-357, 1978-2 C.B.227.

84. See Rev. Proc. 93-27, 1993-2 C.B. 343; cf. *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* 59 T.C.M. (CCH) 236 T.C. Memo (P-H) ¶ 90,162 (1990). But cf. *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

the corporation or imputed transferor.⁸⁵ As with the LLC service provider receiving an interest in the entity for services, individuals receiving stock for services attempt to find service-flavored “property” in order to support a nontaxable exchange under section 351. The transfer of stock to a service recipient often is a critical factor in planning for tax-free incorporations since, if the stock is considered received for services and the service provider receives more than 20% of the stock, all transferors fail the 80% control requirement of section 351, which must be satisfied by transferors of “property.”⁸⁶

10. *Entity Level Taxation.*—Partnerships, including LLCs taxable as partnerships, are not subject to federal income tax. Single member LLCs are ignored for federal income tax purposes unless the owner opts for association treatment. Most states, with the exception of Texas and Pennsylvania, do not tax LLCs although some states impose limited franchise or capital taxes.⁸⁷ Tax items are determined as if the LLC were an individual and are allocated between separately and nonseparately stated items in accordance with section 702. Most tax elections must be made by the LLC,⁸⁸ and income and deductions are characterized at the entity level.⁸⁹ The LLC’s taxable year generally must conform to that of a majority in interest of its members.⁹⁰ Its taxable year will close on a termination or sale of 50% or more of its equity within one year, and it will also terminate with respect to a member who sells, exchanges, or liquidates his or her entire interest.⁹¹

S corporations generally are not subject to corporate income taxes, including the corporate alternative minimum tax, personal holding tax, and accumulated earnings tax. However, C corporations that convert to S status are subject to some entity level taxes. Section 1374 taxes such corporation on net built-in gains recognized within ten years after the conversion, and section 1375 imposes tax on excess passive income if the corporation has undistributed C year earnings and profits. Taxes imposed under either provision are at the maximum corporate rate of 35%, but the taxes reduce the corporate income taxable to the shareholders. For purposes of the built-in gains tax only, prior C year carryovers are permitted to reduce the base of the

85. See IRC § 83(h), Regs. § 1.83-6. See IRC § 1032 (corporation recognizes no gain on receipt of property for its stock).

86. See Regs. §§ 1.351-1(a)(1), (2).

87. See Ely & Grissom, *supra* note 20, at 1005.

88. See IRC § 703(b).

89. See *United States v. Basye*, 410 U.S. 441 (1973). But see IRC § 724; *Casel v. Commissioner*, 79 T.C. 424 (1982); Regs. § 1.267(b)-1(b).

90. See IRC § 706(b). But see IRC § 444 (election of different taxable year).

91. See IRC § 706(c).

tax. In addition, a corporation using the LIFO method of inventory accounting when it converts to S status must recapture the LIFO-FIFO spread over the succeeding four years.⁹² Since conversion of a C corporation to an LLC taxed as a partnership is treated as a corporate liquidation, causing both the corporation and its shareholders to recognize gain or loss with respect to all assets and stock, the entity level taxes on S corporations that were formerly C corporations cannot be counted as a relative disadvantage of the S regime.

An S corporation's taxable income is determined as if the corporation were an individual, and income and deductions are characterized with reference to the corporation's activities and purposes. Most tax elections are made at the corporate level.⁹³ The corporation's taxable year generally must be a calendar year or one that is the same as its principal shareholders' taxable year.⁹⁴ Its taxable year may, at the election of the corporation and its shareholders, be closed in the event of a shareholder's complete termination or where a certain percentage of its stock is sold over a certain period.⁹⁵

11. *Use of Cash Method of Accounting.*—A literal interpretation of sections 446(c) and 448(a), and the definition of "tax shelter" in section 461(I)(3), could support the position that LLCs are not permitted to use the cash method of accounting.⁹⁶ The Service has, however, issued several favorable rulings permitting an LLC to use the cash method if (1) the LLC did not expect to generate losses, (2) the LLC members practiced in the profession in which the LLC is engaged, (3) the LLC was not formed for a tax avoidance purpose, (4) the interests in the LLC were not syndicated, and (5) the equity partners manage the LLC.⁹⁷

An S corporation may adopt the cash method unless it is a "tax shelter" under section 461(I)(3).⁹⁸ As for all taxpayers, if inventories are used the accrual method of accounting must be adopted unless the Service permits otherwise.⁹⁹

92. See IRC § 1363(d).

93. See IRC § 1363(c).

94. See IRC § 1378; see also Rev. Proc. 87-32, 1987-2 C.B. 396.

95. IRC § 1377(a)(2); see generally Regs. § 1.1362-2.

96. For explanations of the terms "syndicate" and "tax shelter" (as specially defined within the § 461(i)(3) definition of the same term), see IRC §§ 1256(e)(3)(B), 6662(d)(2)(C)(iii).

97. See Priv. Ltr. Rul. 94-07-030 (Apr. 15, 1994); Priv. Ltr. Rul. 94-15-005 (Feb. 18, 1994); Priv. Ltr. Rul. 93-21-047 (May 28, 1993) (conversion of law partnership to LLC).

98. See also IRC § 1256(e)(3) (regarding syndicates).

99. See Regs. § 1.446-1(e)(1) (permitting taxpayers to adopt any "permissible" accounting method for each trade or business).

12. *Effects of Entity Level Debt on Outside Basis and Loss Limitation Rules.*—Both LLC members and S shareholders may deduct their shares of entity losses only to the extent of the adjusted bases of their interests in the entity. For LLCs, but not for S corporations, loss deductions are facilitated by the inclusion of the LLC's debt in the members' bases for their interests.

a. *Rules for S Corporations.*—An S shareholder may deduct corporate losses only to the extent of the sum of the shareholder's stock basis and the adjusted basis of any corporate debt held by the shareholder.¹⁰⁰ The basis of stock received from the corporation in a section 351 exchange includes only the money paid and the adjusted basis of any property exchanged for the stock. The shareholder may not add to stock basis any indirect contribution, such as a proportionate amount of corporate indebtedness, even if its repayment has been personally guaranteed by the shareholder. The shareholder obtains basis only by making an "actual economic outlay."¹⁰¹ This limitation often prevents S shareholders from deducting their shares of corporate losses and deductions, although excess losses may be carried forward indefinitely.¹⁰²

An S shareholder is also subject to the at-risk limitations of section 465, which restrict deductions for losses from property to the amount the taxpayer has at risk in the investment. An S shareholder is not at-risk for corporate debt, even personally guaranteed corporate debt.¹⁰³ Symmetrically with the S corporation basis rules, however, the proposed regulations under section 465 permit a shareholder to increase the at-risk amount by funds loaned to the corporation.¹⁰⁴

100. See IRC § 1366(d).

101. *Underwood v. Commissioner*, 535 F.2d 309 (5th Cir. 1976); *Raynor v. Commissioner*, 50 T.C. 762 (1968). But see *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (shareholder entitled to a determination of who was the real debtor). The Tax Court does not follow *Selfe*, except under its administrative *Golsen* rule for cases appealable to the Eleventh Circuit. See *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989).

In one instance, a novation of a corporate debt provided shareholder level basis. *Gilday v. Commissioner*, 43 T.C. Memo (CCH) 1295, T.C. Memo (P-H) ¶ 82,242 (1982); cf. *Underwood v. Commissioner*, *supra*.

102. See IRC § 1366(d)(2).

103. See Prop. Regs. §§ 1.465-24(a)(3), 1.465-6(d). But cf. *Melvin v. Commissioner*, 88 T.C. 63 (1987); *Abramson v. Commissioner*, 86 T.C. 360 (1986). It remains uncertain how a shareholder establishes the initial at-risk amount after the corporation converts from C to S status. In the absence of guidance, it should be assumed that stock (and debt) basis outstanding as of such date is the gross amount, which then must be allocated among the corporation's at-risk activities.

104. See Prop. Regs. § 1.465-10(c).

Moreover, the passive activity loss rules of section 469 apply after the foregoing two loss limitations are hurdled.¹⁰⁵ An S shareholder is separately allocated items of income, deduction, loss, and credit, and these are segregated among items of portfolio income (and directly allocable expense) and the corporation's section 469 activities.¹⁰⁶ Each shareholder then determines to what extent he or she materially (or significantly) participated in each section 469 activity.

b. *Rules for LLCs.*—A well-recognized advantage of the partnership for federal income tax purposes is the ability to include a proportionate share of entity level debt in a partner's outside basis. This enhances a partner's ability to deduct partnership losses currently and facilitates tax-free distributions. This advantage applies to members of LLCs taxed as partnerships. A threshold issue in determining the partner/member's share of entity debt is whether the debt should be characterized as recourse or nonrecourse, based on an "economic risk of loss" analysis.¹⁰⁷ Generally, all of an LLC's debt is nonrecourse if no member is liable for repayment. As nonrecourse debt, it is usually allocated among the members in proportion to their profit ratios.¹⁰⁸ However, a debt may "recourse" with respect to a particular member, to whom the debt must then be allocated, if, for example, the member or a person related to the member guarantees the debt or the debt is loan to the LLC from the member or related person.¹⁰⁹

The at-risk rules also apply to LLC members. Since the debt is typically without recourse to the members, they usually cannot include it in their at-risk amounts unless they have personally liable for repayment or have pledged property as security for the debt.¹¹⁰ Thus, an LLC member who personally guarantees a debt of the entity is considered "at-risk," whereas an S shareholder counterpart may not be.¹¹¹ Also, LLC members should be able to include their shares of nonrecourse debt secured by real estate if the

105. See Temp. Regs. § 1.469-2(d)(5); Jerald D. August, Basis Traps Under Subchapter S: Competing in the Basis Triathlon, in *New York University—Proceedings of the Forty-Eighth Institute on Federal Taxation § 7-1* (1990); Jerald D. August, How Do the Passive Activity Loss Rules Apply to S and C Corporations? 5 *J. Partnership Tax'n* 218 (1988).

106. See generally Regs. § 1.469-4.

107. See Regs. §§ 1.752-1(a)(2), -2(c), -2(d).

108. See Regs. § 1.752-3.

109. Other instances for finding recourse debt in an LLC may exist where the debt falls within the interest guarantee or property pledge rules in Regs. §§ 1.752-2(e) and -2(h).

110. See IRC §§ 465(b)(1), (2).

111. See *Melvin*, 88 T.C. at 63. But see Prop. Regs. § 1.465-6(d).

debt meets the definition of qualified nonrecourse financing in section 465(b)(6).¹¹² This exception is not applicable to S shareholders.¹¹³

The application of the passive activity loss rules to LLCs is uncertain. Section 469(h)(2) precludes a limited partner from satisfying the material participation test, except where the regulations lift this bar. Under the regulations, a limited partner is active as to the partnership's activities if he or she satisfies either (1) the 500 hour material participation test,¹¹⁴ (2) the five out of prior ten year test,¹¹⁵ or (3) the three-year rule applicable to service activities.¹¹⁶ If an LLC member could be considered a general partner, which is presently uncertain, the material participation test could also be satisfied by one of four additional tests.¹¹⁷ A manager-member of an LLC should be treated as a general partner, as should possibly members of a member managed LLC. However, in the absence of further guidance, it should be assumed that members who are not also managers are limited partners for purposes of section 469.¹¹⁸

13. *Distributions Not in Redemption of Stock or LLC Interest*

a. *From S Corporations.*—Distributions received by a shareholder from an S corporation with no earnings and profits are not taxable to the extent of the shareholder's stock basis, which is first adjusted for current year's income (but not deductions or loss).¹¹⁹ A distribution in excess of basis is treated as gain on a sale of property.

If the corporation has accumulated earnings and profits from prior C years, distributions are excluded from gross income until the corporation has exhausted its accumulated adjustments account (AAA), which is essentially the sum of its taxable income for the most recent uninterrupted period of S years.¹²⁰ Under a 1996 amendment, a distribution may be from prior years'

112. To qualify, the debt must be nonrecourse to the entity as well as the members.

113. See IRC § 465(b)(6)(D). Final regulations under the qualified nonrecourse financing exception were recently issued. See T.D. 8777, 63 Fed. Reg. 41,420 (1998).

114. See Temp. Regs. § 1.469-5(a)(1).

115. See Temp. Regs. § 1.469-5(a)(5).

116. See Temp. Regs. § 1.469-5(a)(6).

117. See Temp. Regs. §§ 1.469-5(a)(2), (4).

118. If an LLC member is considered a limited partner, the member is also prevented from qualifying under the "active participation" exception for certain rental real estate activity under § 469(i). See also IRC § 469(c)(7); Prop. Regs. § 1.469-9(f)(1). Perhaps, the use of a general partnership to directly engage in the activity, which is owned by individuals whose interests as general partners are held in single member LLCs, may avoid limited partner status.

119. See IRC §§ 1368(b), (d).

120. See IRC §§ 1368(c)(1), (e).

AAA, even if there is a net negative adjustment to the account for the year of distribution.¹²¹ Distributions from AAA are subtracted from stock basis,¹²² and are gain to the extent they exceed the shareholder's stock basis. Distributions in excess of AAA are taxed as dividends to the extent of C earnings and profits.¹²³ Distributions in excess of both AAA and C earnings and profits are gain on sales of property.

If the corporation distributes appreciated property, it recognizes gain as though it had sold the property to the distributees at fair market value, and this gain is allocated among the shareholders as part of the corporation's taxable income for the year.¹²⁴ If the distribution is of property held by the corporation when it converted from C to S status and occurs within 10 years after the conversion, any built-in gain as of the date of conversion is subject to corporate tax under section 1374. A corporation generally recognizes no loss on distributing property to shareholders,¹²⁵ and this rule presumably trumps section 1374 to disallow recognition of built-in loss.¹²⁶ In all cases, the shareholder-distributee takes a fair market value basis for the property.¹²⁷

Distributions in liquidation are taxable to the corporation in accordance with section 336, which, in the case of a former C corporation, may result in corporate tax under section 1374 for preconversion appreciation in the distributed assets. Since losses are generally permitted to be recognized in a liquidation, built-in losses should be treated as recognized for purposes of section 1374. Capital gain or loss results at the shareholder level, after first making the corresponding passthrough adjustments for current year's income or loss, including income or loss from the liquidating distributions.

b. *From LLCs.*—The tax treatment of distributions to LLC members under Subchapter K is generally more favorable than the results under Subchapter S, especially with respect to distributions of appreciated property. Unless the LLC makes a disproportionate distribution of section 751 property (unrealized receivables and substantially appreciated inventory), it recognizes no gain or loss on distributing property to its members.¹²⁸ A disproportionate distribution occurs if the distributee's interest in section 751 property increases or decreases as a result of the distribution. In the event of

121. See IRC § 1368(e)(1)(C) (applicable for taxable years beginning after 1996).

122. See IRC § 1367(a)(2)(A).

123. See IRC § 1368(c)(2).

124. See IRC §§ 311(b), 1371(a).

125. See IRC § 311(a).

126. See IRC § 1374(d)(4) (defining "recognized built-in loss").

127. See IRC § 301(d).

128. See IRC § 731(b).

such a distribution, section 751 property equal in value to the amount of the increase is deemed sold between the member and the LLC. This stands in marked contrast to the results under Subchapter S, where any distribution of appreciated property is taxable.

Generally, no gain or loss is recognized by a distributee LLC member unless distributions of money or money equivalents exceed the basis of the member's interest.¹²⁹ Marketable securities are treated as money to the extent of their fair market value.¹³⁰ The distributee succeeds to the LLC's adjusted basis for the property, except that this basis cannot exceed the basis of the member's interest immediately before the distribution.¹³¹ Although the character of distributed property in the distributee's hands normally depends on the distributee's use or purpose in holding the property, gain or loss on the distributee's sale or exchange of distributed unrealized receivables or inventory is ordinary, regardless of the distributee's use or purpose.¹³²

Most of the foregoing rules, and a few others, apply to distributions in liquidation of the LLC or of the member's interest. LLC member-distributees generally recognize no gain or loss on liquidation. However, cash distributions in excess of the basis of the member's interest are taxable, and relief from indebtedness (net of debts assumed or taken subject to) and certain marketable securities are treated as cash for this purpose. If a member receives only money in liquidation of his or her interest, loss is recognized to the extent the distribution is less than the basis of the member's interest.¹³³ If the liquidation distribution is disproportionate as to section 751 property, gain or loss is recognized.¹³⁴ Distributed unrealized receivables and inventory bear an ordinary-income taint under section 735(a).

129. See IRC § 731(a)(1); Regs. § 1.731-1(a)(1)(ii) (treating advances and draws as distributions on the last day of the relevant taxable year). Money includes any reduction in the partner-distributee's share of partnership liabilities. IRC § 752(b).

An LLC member who has contributed appreciated property to the LLC may, however, recognize gain as a result of two types of distributions. Under § 737, the contributing partner recognizes gain on receiving a distribution within seven years after the contribution and while the LLC continues to hold the contributed property if the value of distributed property other than money exceeds the basis of the member's interest. Under § 704(c)(1)(B), the contributing partner may recognize gain if the contributed property is distributed to another member within seven years after the contribution.

130. See IRC § 731(c) (applicable to distributions made after December 8, 1994, subject to various transitional rules). This rule is subject to a few exceptions, including distributions of originally contributed securities and distributions from "investment partnerships." IRC § 731(c)(3).

131. See IRC § 732(a)(2).

132. See IRC §§ 735(a).

133. See IRC § 731(a)(2).

134. See *Yourman v. United States*, 277 F. Supp. 818 (S.D. Cal. 1967); Rev. Rul. 77-412, 1977-2 C.B. 223.

Liquidation analysis is required where there is a constructive termination under section 708, which may result in a bunching of income for more than a 12-month period with respect to LLC members.

14. *Redemptions of Stock and Interests*

a. *S Corporations*.—Distributions in redemption of S stock are either nonexchange events, subject to the rules for ordinary distributions, or exchange events. A redemption is considered a sale or exchange of the redeemed stock if the shareholder's interest is meaningfully reduced (section 302(b)(1)), the redemption meets the substantially-disproportionate test of section 302(b)(2), the shareholder's interest in the corporation is terminated (section 302(b)(3)), or the redemption is made to pay death taxes (section 303). In determining gain or loss on a redemption qualifying for exchange treatment, stock basis is adjusted for corporate income and loss for the year of redemption, which may be closed on the redemption date by election of the corporation and its shareholders.¹³⁵ Gain or loss is generally capital, and installment sale reporting may be available.

If a redemption does not qualify for exchange treatment, the distribution is treated under section 1368. If the corporation does not have accumulated earnings and profits for years before the S election, the distribution is nontaxable to the extent of the shareholder's basis, and any amount by which the distribution exceeds basis is usually long-term capital gain. If the corporation has undistributed C year earnings and profits, the distribution is first a nontaxable distribution of the AAA (generally consisting of S period taxable income), second a dividend to the extent of the C earnings and profits, and third gain on a sale of the stock.¹³⁶ If the redeemed shareholder has a high stock basis, nonexchange treatment is frequently advantageous because it facilitates recovery of stock basis and, where a large AAA is available, a dollar-for-dollar allocation to the account.

A redemption generally has no direct tax impact on the corporation unless the distribution is made with appreciated property, in which event gain is recognized under section 311(b). Unlike the ability of a tax partnership to make a section 754 election, no adjustment is made to the basis of either the corporate assets or the stock of the nonredeeming shareholders. If the redemption qualifies as an exchange, earnings and profits are proportionately reduced. If it is not an exchange, the charge to earnings and profits is the amount of any dividend.

135. See IRC § 1377(a)(2).

136. See IRC § 1368(c)(2).

b. *Redemption of LLC Interests.*—Complete liquidation of an LLC member's interest may be accomplished by one distribution or a series of distributions, even in a two member context.¹³⁷ The departing member generally recognizes no gain or loss, except to the extent that money distributed or deemed distributed exceeds basis.¹³⁸ If the LLC's business is performing services (that is, if capital is not a material income producing factor), payments for the member's interest in the LLC's unrealized receivables or goodwill qualify for special treatment under section 736(a).¹³⁹ These payments are taxed as ordinary income to the recipient and the entity-payer's income is correspondingly reduced. Other distributions in liquidation of a member's interest are governed by the rules for distributions described above. If the other distributions are a series of payments, the redeemed member offsets the distributions against basis, and money distributions are gain only after basis has been fully recovered.¹⁴⁰ Loss is usually recognized, if at all, only when the final distribution is received, but ratable reporting may be elected to accelerate the loss.

15. *Sales or Exchanges of Equity Interests*

a. *S Corporations.*—An S shareholder's sale of part or all of his or her stock usually results in long-term capital gain or loss.¹⁴¹ However, unlike the situation of a partner, the amount realized in the sale does not include any portion of the S corporation's debt. The shareholder's stock basis is adjusted for income, loss, and distributions through the date of sale. If the sale is of all of the shareholder's stock, an election may be made to close the corporation's tax year as to the shareholder if the necessary consents are given by the corporation and its shareholders and the termination election is filed with the corporation's return.¹⁴² If the election is not made,

137. See Regs. §§ 1.736-1(a)(6), 1.761-1(d). If a series of distributions is made to a departing member of a two-member LLC, the departing member continues to be recognized as a member for tax purposes until the liquidation is completed.

138. See IRC § 731(a)(2); see also *supra* text accompanying notes 133-134.

139. Section 736(a) payments, which are treated as either a distributive share of LLC income or as a guaranteed payment, are not subject to the disproportionate distribution rules of § 751(b).

140. Regs. § 1.736-1(a)(1). Ratable basis reporting may be elected. Regs. § 1.736-1(b)(6).

141. But see IRC § 341(a). Under the passive loss rules of § 469, gain or loss from a sale of S stock is allocated among the corporation's various activities as if it had sold all of its assets. Portfolio assets of the S corporation are treated as a single activity. If the shareholder's interest is completely terminated in a taxable event, all prior suspended passive activity losses, as well as any loss on the disposition, is freed from the constraints of § 469.

142. See IRC § 1377(a)(2). Also, if a shareholder disposes of 20% or more of the corporation's stock during a 30-day period, the corporation may elect to close the books as of the date of disposition for allocation purposes. Regs. § 1.1368-1(g)(2). See also IRC

the normal daily allocation of tax items applies, and the selling shareholder is allocated a pro rata share of income or loss for the entire year, based on the number of days such person owned stock.

S corporations may engage in tax-free reorganizations pursuant to section 368. Generally, S shareholders recognize no gain or loss on stock exchanges pursuant to a plan of reorganization.¹⁴³ This is perhaps the most striking difference between S corporations and LLCs taxed as partnerships, which cannot be parties to a reorganization.

b. *Limited Liability Companies.*—Gain or loss on a sale of an interest in an LLC is usually capital gain or loss under section 741, but if the LLC has unrealized receivables or inventory, a portion of the amount realized in the sale is allocated to the member's share of these assets, and this is treated by section 751 as received on a sale of property that is not a capital asset. The amount realized on the sale includes the cash and the value of other property received and the selling member's share of LLC liabilities.¹⁴⁴ The basis of the interest sold is adjusted for the member's distributive share of the LLC's profit or loss for the year of sale.¹⁴⁵ If the member's sale is of his or her entire interest, the LLC's year closes on the date of sale.¹⁴⁶ Installment sale reporting is not available to the extent of the selling member's share of LLC assets that are not eligible for installment sale reporting.¹⁴⁷ For example, installment reporting is unavailable for the portion of the amount realized that is attributable to recapture amounts under section 1245 or section 1250.

The purchaser of an LLC interest has an initial basis for the interest equal to the sum of cost and an allocable share of LLC liabilities. Following a sale of an interest or a transfer at death, an LLC, unlike an S corporation, may, under section 743(a), adjust the inside basis of its assets to reflect the outside basis of the new holder of the interest.¹⁴⁸ These adjustments provide substantial estate planning benefits for family businesses operated as LLCs.

§ 1362(e)(6) (automatic termination of books where sale of 50% or more of stock occurs in S termination year).

143. See IRC § 354(a)(1).

144. See IRC § 752(d).

145. See Regs. § 1.705-1(a)(1).

146. See IRC § 706(c)(2)(A). If the member sells less than the entire interest, the varying interest rule of § 706(c)(2)(B) applies.

147. See IRC § 453(i).

148. The adjustment may be made only if the partnership makes an election under § 754, which has future consequences for the LLC and its members that should be considered before the election is made.

An LLC, unlike an S corporation, may not be a party to a tax-free re-organization.¹⁴⁹ However, some partnership conversions are not taxable.¹⁵⁰

III. WHERE ART THOU SUBCHAPTER S?

The preceding comparison reveals several advantages of Subchapter K over Subchapter S, and some that S has over K, but the overall advantage lies with Subchapter K, especially after the states' widespread adoption of LLC legislation and the Treasury's issuance of the CTB regulations. The question that must be asked, especially by one who has lived within the hybrid world of Subchapter S for many years, both as a tax practitioner and commentator, is: Why hasn't Congress placed Subchapter S on a level playing field with its passthrough siblings?¹⁵¹

Several reasons for this inequity are plausible. The continuing restrictions on Subchapter S may reflect an anxious preoccupation by the Treasury over the exodus from Subchapter C to Subchapter S that occurred in response to the 1986 repeal of the *General Utilities* doctrine.¹⁵² The exodus from C to S directly impacted the balanced budget debate since any reform or liberalization of Subchapter S, regardless of its merit, would be scored by the Joint Committee on Taxation as losing revenue.¹⁵³ Given that the Treasury has arguably given the house away with the CTB regulations, it is paradoxical that statutory liberalizations of Subchapter S are tightly restricted by budget considerations. This discrimination against S corporations was most noticeable during the process which led to Congress' enactment of 17 "reforms" to Subchapter S in 1996.¹⁵⁴

149. See IRC § 1031(a)(2)(D) (nonrecognition rule of § 1031 does not apply to exchange of partnership interest).

150. See Rev. Rul. 84-52, 1984-1 C.B. 157.

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

152. The decision in *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935), is usually considered the genesis of the rule that a corporation recognized no gain or loss on distributions of property to its shareholders, including distributions in liquidation. The doctrine, after having been eroded by successive amendments to § 311(b), was repealed in 1986 by a further revision of § 311(b) and the enactment of the present § 336. See IRC §§ 337(d) (authorizing legislative regulations to prevent circumvention of §§ 336, 1374); 1374 (built-in gains tax applicable to former C corporations for ten years after they elect S status).

153. The word "scored" refers to the revenue estimate made by staff economists with the Joint Committee on Taxation.

154. The 1996 amendments were enacted by the Small Business Jobs Protection Act of 1996, Pub. L. No. 104-188, §§ 1301-1317(b), 110 Stat. 1755, 1777-87 (1996). The Subchapter S amendments originated in a bill introduced by Senators Danforth and Pryor, *S Corporation Reform Act of 1993*, S. 1690, 103d Cong. For an extended discussion of the

One of the reforms most desired by tax professionals is a rule allowing an S corporation to issue plain vanilla preferred stock. The purpose of this reform was overwhelmingly benign. The one class of stock rule, which has been part of the Subchapter S landscape since its enactment in 1958, restricts an S corporation from issuing more than one class of equity, with differences in voting rights being ignored. Under the one class limitation, an individual advancing funds to a family S corporation may receive a distribution priority reflecting investment risk only if the contribution is booked as debt. Intrafamily debt, even if subordinated, may limit the corporation's ability to raise additional capital in the form of either debt or equity. Even if an intrafamily cash infusion is intended to be debt, it could be considered a disqualifying second class of stock if the obligation's terms and conditions, or its repayment, do not fall within the safe harbor for straight debt.¹⁵⁵

The one class of stock rule also unfairly restricts an S corporation's access to venture capital and more sophisticated forms of financing. Commercial lenders, in addition to fixed payments of interest, frequently insist on receiving equity-like payments (kickers) as consideration for the risk they assume. Often, a commercial lender will extend financing only if it receives a right to convert its debt into equity. No similar tax penalty applies to hybrid or equity-flavored debt of an entity taxable as a partnership.

Legislation permitting S corporations to issue preferred stock is long overdue. The justification sometimes offered for the one class rule—that it avoids income shifting and complex allocations of income and loss—has long been out of touch with business reality. The only rationale for the rule must be that an amendment allowing preferred stock would be scored as a revenue loser.¹⁵⁶

A bill introduced by Senators Pryor and Danforth in 1993, which contained several of the reforms enacted in 1996, would have allowed an S

amendments, see generally Jasper L. Cummings & Samuel P. Starr, *The Impact of the New S Corporation Revisions*, 85 J. Tax'n 197 (Oct. 1996).

155. Section 1361(c)(5) defines straight debt as a (1) written instrument containing (2) an unconditional promise to pay on demand on date certain (3) in money, provided that (4) the interest rate and payment dates are not contingent on profits, the borrower's discretion, or similar factors, (5) the debt is not convertible, directly or indirectly, into stock of the debtor, and (6) the creditor is individual who is eligible to own S stock. A 1996 amendment relaxes the latter requirement by permitting a person who is actively and regularly engaged in the business of lending money to hold straight debt. See IRC § 1361(c)(5)(iii) (enacted by P.L. 104-188, § 1304, 110 Stat. 1755 (1996)).

156. Corporations holding preferred stock of other corporations have long been allowed the deduction for dividends received for dividends on these investments. IRC § 243; Regs. § 1.1502-26. But see IRC § 1059 (basis reduction for nontaxed portions of certain extraordinary dividends).

corporation to issue preferred stock that (1) is nonvoting, (2) is limited and preferred as to dividends, so as not participate in the corporation's growth, and (3) has redemption and liquidation rights not exceeding the issue price of the stock, plus a modest redemption or liquidation premium.¹⁵⁷ Under the bill, only persons eligible to hold S common stock could be preferred shareholders [or, ownership of qualifying preferred stock was not restricted to persons eligible to hold S common stock.] However, the preferred stock proposal was dropped from the legislation passed in 1996, a victim of negative scoring.

Juxtaposed against the one class of stock straightjacket, an unincorporated entity taxed as a partnership can issue multiple classes of equity interests, regardless of the holder's identity, without losing conduit tax status.¹⁵⁸ For example, a generous grandmother could receive a preferred interest in capital for her advance to an LLC organized by her granddaughter, with the granddaughter holding the common or residual interest.¹⁵⁹ The venture capital lender can easily receive a hybrid interest or kicker in lending funds to a partnership, and debt instruments issued by partnerships may be convertible.

One reform that survived the scoring process is a rule permitting S stock to be owned by a tax-exempt organization described in section 401(a) (qualified pension, profit sharing, and bonus plans) or section 501(c)(3) (charities).¹⁶⁰ However, a tax-exempt organization's allocable share of S income, and gain on its sale of S stock, is automatically classified as unrelated business taxable income (UBTI) unless the organization is an employee stock ownership plan (ESOP).¹⁶¹ Partnerships have always been allowed to have tax-exempt organizations as partners, and the UBTI rule for them is less restrictive. A tax-exempt partner's distributive share of an item of partnership income is UBTI only if it is income of a trade or business regularly carried on by the partnership that is unrelated to the organization's exempt purpose.¹⁶² A tax-exempt partner's share of partnership dividends,

157. See S Corporation Reform Act of 1993, *supra* note 154.

158. Special withholding rules apply to the distributive shares of foreign partners. See IRC § 1446.

159. This structure may, however, raise estate and gift tax concerns, especially if distributions are not made regularly on the preferred interest. See IRC §§ 2701(a), (d) (imputed transfer tax on cumulative unpaid distributions); see also Jerald D. August, *Special Transfer Tax Valuation Rules for Interests in Family Owned Enterprises: The Micro-Surgery of Chapter 14*, in *New York University—Proceedings of the Fifty-Fourth Institute on Federal Taxation* § 3-1 (1996).

160. See IRC § 1361(c)(6) (effective for taxable years beginning after 1997).

161. See IRC § 512(e). The exception for ESOPs was added in 1997, but it is effective as though it were included in the 1996 legislation.

162. See IRC § 512(c).

interest, royalties, and capital gains thus is usually not UBTI. In finally allowing S shareholders to make gifts of S stock to charity, why did Congress make the rule for owners of S corporations more restrictive than that for partners? Again, the assumed culprit must be the scoring process, which result comes at the expense of fairness.

The slow pace of Subchapter S reform stands in contrast with the process by which the CTB regulations dramatically altered partnership taxation. Ironically, CTB, whose precursor was a series of rulings mapping the way for LLCs to be characterized as partnerships,¹⁶³ came by administrative fiat and did not receive formal congressional approval. The logic behind the Service's and Treasury's largesse was presumably that since partnerships and LLCs had already evaded Subchapter C, generous allowance of partnership status to newly-organized entities would not directly reduce federal revenues. The contradictory treatment of S corporations and partnerships may be blamed upon the process by which the Treasury is authorized to issue regulations under existing law for unincorporated PBFs, while the consensus building and deficit conscious processes of Congress must apply to Subchapter S reform.

IV. EVOLUTION OF SUBCHAPTER S: WHY CONGRESS SHOULD FURTHER AID S CORPORATIONS

In enacting Subchapter S in 1958, Congress' conception of the profile of S investors was very restrictive.¹⁶⁴ The first generation of S investors suffered from various organizational and operational handicaps. S corporations could not have more than 10 shareholders, could only issue one class of stock, and could not issue hybrid debt or debt to an ineligible shareholder without assuming substantial tax risk. Since trusts were not permitted shareholders, S shareholders were severely restricted in achieving customary estate planning objectives, especially in planning for multi-generational ownership of S stock. Congress apparently intended that more sophisticated incorporated businesses, possessing more complex organizational and capital structures and requiring more sophisticated estate planning, should be subject to the double tax regime of Subchapter C, which, until 1986, reflected a strong tax bias in favor of liquidation strategies to avoid double taxation.

In contrast, Subchapter S was designed to be utilized only by small businesses, such as the corner grocery store, pharmacy, or closely-held accounting or law firm. The intent was to allow smaller businesses to incorporate but be taxed like partnerships, allowing passthrough of start-up

163. See *supra* text accompanying note 5.

164. S. Rep. No. 1983, 85th Cong., 2d Sess. 87-89, 216-26 (1958), reprinted in 1954 U.S.C.C.A.N. 4791, 4876-78, 5005-14 and 1958-3 C.B. 922, 1008-10, 1137-47.

losses and only one level of taxation once the business became profitable. The single class of stock limitation promoted administrative efficiency by avoiding complex allocation and assignment of income issues. Given the initial landscape of Subchapter S, it is surprising that Congress did not impose an economic size limitation, based, for example, on gross assets or receipts.¹⁶⁵ Early rumblings of a size limitation on S corporations, at least for C corporations converting to S status, may now be heard.¹⁶⁶

Congress' first major changes, the Subchapter S Revision Act of 1982, occurred after Subchapter S had been on the books for 24 years.¹⁶⁷ They liberalized the eligibility rules, authorized nonvoting common stock, and introduced a safe harbor for straight debt. The rule permitting nonvoting common was long overdue because it presented no tax shifting or special allocation opportunities. The straight debt safe harbor allowed S corporations with less favorable debt-equity ratios to avoid a termination for having a second class of stock.¹⁶⁸ Also, Congress eliminated the sinister rule terminating S status retroactively to the beginning of the year in which a termination event occurred, substituting rules under which a termination takes effect not earlier than the date of the terminating event.

165. See, e.g., IRC §§ 55(e)(1) (corporation with average annual gross receipts for preceding three years not exceeding \$7.5 million exempt from corporate alternative minimum tax), 448(c) (average annual gross receipts ceiling for using cash method of accounting), 474(c) (permitting certain small businesses, based on gross receipts test used in § 448(c), to use simplified dollar value method of LIFO accounting), 1202(d)(1) (special capital gains exclusion restricted to C corporations with gross assets not exceeding \$50 million), 1244(c)(3) (limitation on ordinary loss treatment with respect to stock in small business corporation based on shareholder contributions), 2033A (federal estate taxation exclusion for family-owned business interests limited by dollar value).

166. President Clinton, in his package of budget proposals issued on February 10, 1997, recommended that a C to S conversion be treated as a deemed liquidation if the corporation had a value exceeding \$5 million at the time of the conversion. The proposal, which the Administration later dropped, would have repealed the built-in gains tax for corporations subject to this rule. See Jerald D. August, *The Proposed Blockade of C to S Conversions: The Application of Gunboat Diplomacy to Corporate Taxation*, 9 *J. S Corp. Tax'n* 107 (1997).

167. See Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 1361, 96 Stat. 1669 (1982). Many of the 1982 changes were recommended in Staff of the Joint Committee on Taxation: *Recommendations for Simplification of Tax Rules Relating To Subchapter S Corporations*, 96th Cong., 2d Sess. (Comm. Print 1978). Earlier, in 1969, the Treasury proposed Subchapter S reform. U.S. Treasury Dep't, *Technical Explanation of Treasury Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5228 (1969). The Tax Reform Act of 1976 made minor fixes to Subchapter S, most notably the rules permitting grantor trusts, voting trusts, and some testamentary trusts to be shareholders.

168. Straight debt may, however, be equity for other purposes. See IRC § 385.

The 1982 reforms substantially streamlined the distribution rules, replacing a Byzantine set of distribution tiers, first separated into money versus property categories, in determining whether a distribution was a return of basis, a distribution in excess of basis, or a dividend from earnings and profits from C or even S years.¹⁶⁹ Finally, losses in excess of a shareholder's stock and debt basis are not vaporized forever as under prior law, but may now be carried forward indefinitely, although they are not transferable and, until 1996, could not be used against gain from a sale of stock.

The next wave of Subchapter S legislation occurred in 1986. Before 1986, a former C corporation was subject to a corporate tax on its capital gains in excess of \$25,000 for the three years following a conversion to S status.¹⁷⁰ The tax was designed to prevent one-shot S elections in order to bail out large appreciated assets at a single round of capital gains tax. The bite of former section 1374 was not as strong as its bark.¹⁷¹

The 1986 legislation repealed the *General Utilities* doctrine, substituting rules requiring corporations to recognize gain on distributions of appreciated property to shareholders.¹⁷² In order to prevent C to S conversions from being a means of avoiding *General Utilities* repeal, a more imposing backstop than former section 1374 was needed. As revised in 1986, section 1374 imposes corporate tax on the built-in appreciation in corporate assets at the time of a C to S conversion if these assets are sold or otherwise

169. The 1982 revisions made it impossible for a corporation to have earnings and profits for an S year, and in 1996, Congress allowed S corporations to eliminate earnings and profits accumulated in pre-1983 S years. See Small Business Jobs Protection Act § 1311.

170. See IRC § 1374 (before amendment in 1986).

171. The most common technique for circumventing former § 1374 was an installment sale providing for minimal, if any, principal payments during the three years following the conversion. A balloon payment in year four would not be subject to the corporate tax. This strategy was specifically stripped of its effectiveness shortly after enactment of the 1986 legislation. See Announcement 86-128, 1986-51 I.R.B. 22. See Jerald David August, The 'BIG' Tax Under Section 1374: Blocking the Erosion of Corporate Level Taxation in a Post-*General Utilities* World, Parts I and II, *Corporate Tax and Business Planning Review* (March & April, 1996).

172. Former § 337 permitted a corporation to avoid corporate gain on sales of capital and § 1231 assets, as well as bulk sales of inventory to a single buyer. In order to avoid corporate recognition, the corporation had to adopt a plan of liquidation and complete the sale and liquidation within one year. Section 337 did not apply to recapture amounts or nonqualifying sales of inventory. Shareholder nonrecognition was possible under § 333, under which a shareholder's gain on liquidation was limited to a ratable share of corporate earnings and profits, which was taxed as ordinary income. The § 333 liquidation required some fancy dancing since all distributions in liquidation had to be made within one calendar month. Sections 333 and 337 could not be used in tandem. See George K. Yin, *Taxing Corporate Liquidations (and Related Matters) after the Tax Reform Act of 1986*, 42 *Tax. L. Rev.* 573 (1987).

disposed of during the subsequent ten years.¹⁷³ Section 1374, as amended in 1986, is designed to tax appreciation accrued before the effective date of the conversion.¹⁷⁴

Although trapping accrued C gains for ten years may seem to be an appropriate policy, the revision of section 1374 added complexity and cost (e.g., need for appraisals, difficult burden of proof issues on whether gain accrued before or after conversion), and it has the added detriment of forced double taxation. Built-in gains are taxed at the maximum corporate rate and are then passed through to the shareholders for inclusion on their individual returns. The tax is allocated among the shareholders, who may deduct their shares as a loss.¹⁷⁵ In contrast, if the corporation had remained a C corporation, shareholder-level tax would be imposed only if and when the corporation distributed the net proceeds of the asset sale as dividends. Since the amount taxable under §1374 may not exceed the corporation's entire taxable income for the year,¹⁷⁶ the tax may be reduced or avoided by planning deductible expenditures for the year of sale, but if net built-in gain year exceeds taxable income for the year, the excess is carried forward as built-in gain for the following year.¹⁷⁷ The Service further closed the door on installment sale transactions designed to circumvent the corporate tax, including installment sales entered into before the conversion.¹⁷⁸

The revised section 1374 has been criticized by practitioners and commentators as imposing too severe a price for converting from C to S. Most troublesome is the ten-year window of continued corporate tax on pre-

173. Other roadblocks to C to S conversion strategies are the tax on excess passive investment income under § 1375 and corresponding termination rule under § 1362(d)(3)(A), and the LIFO recapture rule of § 1363(d), although no recapture of business credits arises by virtue of the election. See IRC § 1371(d)(1). Other consequences of a conversion are loss of fringe benefit exclusions for more than 2% shareholders, a proscription against qualified retirement plans making loans to participant-shareholders, loss limitation rules at the shareholder level, the inability to use carryovers from C years except in computing the built-in gains tax, and application of the at-risk and passive activity loss rules at the shareholder level. Moreover, the corporation must account for its AAA.

174. Some corporations that converted to S status after 1986 but before 1988 were granted transitional relief based on the value of the corporation on August 1, 1986, generally resulting in full or partial use of former § 1374. See Regs. § 1.1374-1A; Rev. Rul. 86-141, 1986-2 C.B. 151, modified by Notice 88-134, 1988-2 C.B. 559; Priv. Ltr. Rul. 92-18-019 (Jan. 23, 1992).

175. See IRC § 1366(f)(2). The character of the loss is determined by allocating net gain proportionately among the recognized built-in gains. See *id.*

176. See IRC § 1374(d)(2).

177. IRC § 1374(d)(2)(B) (applicable to corporations that filed S elections after March 30, 1988).

178. See Regs. § 1.1374-4(h)(1); Notice 90-27, 1990-1 C.B. 336; see also IRC § 337(d); Regs. § 1.1374-9 (anti-stuffing rules).

conversion appreciation. On the other hand, the features of the section 1374 tax may reflect the Treasury's concern about the number of C to S conversions resulting from the 1986 changes and the expected revenue drain from the exodus out of Subchapter C.¹⁷⁹

After 1986, the Service and the Treasury wanted dam the flood of C to S conversions even further, perhaps because the number of C to S conversions that would occur as a result of the 1986 legislation had been underestimated. The tool selected was regulations under the one class of stock rule. The case law under this rule had been generally favorable to S corporations and their shareholders.¹⁸⁰ The first set of proposed regulations under a revised one class of stock rule, issued in October, 1991,¹⁸¹ may fairly be described as draconian and strayed well beyond the legislative history of the purpose of the one class of stock limitation.¹⁸² For example, all debt not qualifying for the straight debt safe harbor was automatically recharacterized as a second class of stock.¹⁸³ A nonconforming distribution rule would have raised the specter of a second class of stock whenever any economic benefit flowed from the corporation to shareholders disproportionately with stock ownership.¹⁸⁴ Under this rule, actual and constructive distributions, compensation, fringe benefits, and numerous other types of payments would have had to have been analyzed closely. This nonconforming distribution rule had all the characteristics of an interrum provision. Its policy objectives were greatly exceeded by the applicable sanction of a termination. In-the-money options were also targeted for second class of stock treatment.

The regulations were to be given retroactive application. In addition to the other defects evident in the proposed regulations, this last feature caught the attention of Senator David Pryor, former Chairman of the Senate Oversight Subcommittee of the Senate Finance Committee, who labeled this provision a "dirty trick" on small and family owned business.¹⁸⁵

179. See generally, Nelson, *supra* note 28.

180. See *Portage Plastics Co. v. United States*, 486 F.2d 632 (7th Cir. 1973); *Amory Cotton Oil Co. v. United States*, 468 F.2d 1046 (5th Cir. 1972); *Stinnett v. Commissioner*, 54 T.C. 221 (1970); *Gamman v. Commissioner*, 46 T.C. 1 (1966).

181. See *One Class of Stock Requirement*, 55 Fed. Reg. 40,870 (1990), reprinted in PS-4-83, 1990-2 C.B. 864.

182. See Jerald D. August, Editor's Comment: *The Subchapter S Termination Act?* 3 J. S. Corp. Tax'n 53 (1991).

183. See *One Class of Stock Requirement*, 55 Fed. Reg. at 40,873 (former Prop. Regs. § 1.1361-1(f)(3)(ii)), reprinted in PS-4-73, 1991-2 C.B. 1092.

184. See *id.* (former Prop. Regs. § 1.1361-1(f)(2)(ii)).

185. See 137 Cong. Rec. S1852-02 (daily ed. Feb. 7, 1991) (statement of Senator Pryor). In response to sharp criticism voiced from the professional community, as well as from Senators Pryor and Bumpers, the Service later announced that the proposed regulations would

Retreating from the criticism and controversy generated by its initial proposals, the Service issued new proposed regulations, completely replacing the first set.¹⁸⁶ The final regulations, issued in May 1992, were much softer and gentler and generally were well received by the professional community.¹⁸⁷

The one class of stock regulation project, which was a public relations debacle for the Service and the Treasury, fostered a belief among tax professionals and the business community that Subchapter S was in need of assistance. Statutory revisions to Subchapter S were proposed in 1993 by Senators Pryor and Danforth,¹⁸⁸ which included the following:

1. Increase the maximum number of shareholders to 75;
2. Provide family attribution for shareholder counting;
3. Permit exempt organizations to be S shareholders;
4. Allow nonresident alien shareholders, and extend the partnership withholding rules of section 1446 to foreign S shareholders;¹⁸⁹
5. Allow discretionary trusts to own S stock;
6. Permit S corporations to issue simple preferred stock;
7. Permit financial institutions to hold safe harbor debt, and permit some convertible debt to be safe harbor debt;

only apply prospectively. A proposed legislative override was introduced. Tax Simplification Bill of 1991, H.R. 2777, S. 1394, 102d Cong., § 401 (1991). A few of the articles on the proposed regulations include Richard D. Blau & Bruce N. Lemons, *S Corps. May Face Retroactive Terminations Under Prop. Regs. On Single Class of Stock*, 74 *J. Tax'n* 24 (1991); Jack S. Levin & Philip A. Stoffregen, *New "S" Second-Class of Stock Proposed Regulation—A Gigantic Trap*, 50 *Tax Notes* 641 (Feb. 11, 1991); Richard M. Lipton, *The Proposed One Class of Stock Regulations: A First Class Problem*, 49 *Tax Notes* 695 (Nov. 5, 1990). This author suggested that the proposed regulations, if finalized, would effectively cause the death of Subchapter S. See August, *supra* note 182.

186. See *One Class of Stock Requirement*, 56 *Fed. Reg.* 38,392 (1991), reprinted in PS-4-73, 1991-2 C.B. 1092.

187. See T.D. 8419, 1992-2 C.B. 217; Robert Cassanos, *Subchapter S: Living With the New One Class of Stock Regulations and Other Limitations on Stock Ownership*, in *New York University—Proceedings of the Fiftieth Institute on Federal Taxation § 5-1* (1992); Scott N. Carlson, *One Class Graduates: Final Regulations Define One-Class-Of-Stock Requirement*, 4 *J. S Corp. Tax'n* 241 (1993).

188. See *S Corporation Reform Act of 1993*, *supra* note 154.

189. This recommendation was made to conform to treaty nondiscrimination requirements. See, e.g., *Convention Between the Government of the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, Dec. 31, 1975, art. 24, ¶ 5, 31 *U.S.T.* 5668, 5687.

8. Extend inadvertent termination relief to inadvertent defective elections;
9. Repeal the entity-level audit rules for S corporations;
10. Repeal the rule making the presence of excess passive investment income for three years a termination event;
11. Allow S corporations to have subsidiaries, including a wholly owned subsidiaries;
12. Conform the basis adjustments for losses and distributions to the partnership rules of section 705;
13. Broaden the application of Subchapter C to S Corporations;¹⁹⁰
14. Eliminate pre-1983 earnings and profits from S years;
15. Apply the C corporation rules for fringe benefit purposes;¹⁹¹ and
16. Permit ordinary losses to the extent of a shareholder's "ordinary income basis" for distributions in complete liquidation.

After these proposals wound their way through congressional processes for several years, Congress, in 1996, enacted several Subchapter S reforms, which were significantly watered down from those of Pryor-Danforth Bill.¹⁹²

190. In Gen. Couns. Mem. 39,768 (Dec. 1, 1988), the Service acknowledged that § 1371(a)(2)—which until its repeal in 1996 required that an S corporation, as shareholder of another corporation, "be treated as an individual"—did not prevent an S corporation from being a party to a tax-free reorganization or division. However, in Priv. Ltr. Rul. 88-18-049 (Feb. 10, 1988), the Service ruled that an S corporation could not make a qualified purchase of a target corporation's stock under § 338 or liquidate a controlled subsidiary under §§ 337 and 332. The Service later changed its position, allowing a qualified stock purchase by an S corporation if the controlled subsidiary was immediately liquidated. Tech. Adv. Mem. 92-45-004 (July 28, 1992). See generally Jerald D. August, *Taxable Stock Acquisitions by S Corporations: Technical Advice Memorandum 9245004 Permits Use of Sections 332 and 338*, 5 J. S Corp. Tax'n 203 (1994); Seth M. Zachary & Philip R. Weingold, *Stock Acquisitions and Liquidations by S Corporations: Availability of Benefits Afforded by Sections 332 and 338*, 20 J. Corp. Tax'n 211 (1993). See also Jerald D. August, *Integration of Subchapter C with Subchapter S After the Subchapter S Revision Act*, 37 Fla. L. Rev. 491 (1985).

191. This proposal would have repealed § 1372, which requires S corporation's shareholders who are more than 2% shareholders to be treated as partners in a partnership for employee fringe benefit purposes. For the consequences of such treatment, see IRC § 162(l)(5).

192. Pub. L. No. 104-188, 110 Stat. 1755 (1996). See Jerald David August, *S Corporations: New Law Liberalizes S Corporation Provisions*, 14 J. Partnership Tax'n 50 (1997); Steven R. Looney, *Miscellaneous S Corporation Changes Made by the Small Business Job Protection Act of 1996*, 8 J. Corp. Tax'n 346 (1997); Joel H. Sharp, Jr. & Hewitt B. Shaw, Jr., *Subchapter S Reform: the Small Business Job Protection Act of 1996*, 24 J. Corp. Tax'n 3 (1997).

The most beneficial of the reforms is new section 1361(b)(3), which allows an S corporation to elect to treat a wholly-owned subsidiary as a division or branch for federal tax purposes.¹⁹³ A "qualified subchapter S subsidiary" (QSUB) is thus included in the S corporation's conduit system, even though it is a separate legal entity under state law. An S corporation can also hold an uninterrupted chain of QSUBs.¹⁹⁴ The QSUB thus resembles the tax nothing construct of the CTB regulations for conduit entities with only one owner. A related provision of the 1996 legislation repealed the rule that formerly barred an S corporation from owning 80% or more of the voting and value of an issued stock of a C corporation.¹⁹⁵

The QSUB rule allows a segregation of assets and liabilities among various lines of business and reduces the administrative complexities and inefficiencies of multiple brother-sister S affiliates. Since an S corporation can now own any percentage of stock of a C corporation, or immediately elect QSUB status where it acquires all of the stock of a target, it will no longer be required to immediately liquidate an acquired corporation to preserve S status.

The second most notable change among the 1996 revisions is the provision for electing small business trusts (ESBTs).¹⁹⁶ Added to the list of trusts that may own S stock, the ESBT fulfills the wishes of many estate planners to allow accumulation or discretionary (nongrantor) trusts to be S shareholders. Until 1996, a trust could own S stock only if it was a grantor

193. The requirements of a QSUB are that it must be (1) a domestic corporation (2) that is not an "ineligible corporation" (a financial institution using the reserve method of accounting for bad debts, an insurance company taxed under Subchapter L, a § 936 corporation, or a DISC or former DISC), (3) 100% of the stock of which is owned by the S corporation parent, and (4) which the S corporation elects to treat as a QSUB. See Prop. Regs. §§ 1.1361-2 to -5; Notice 97-4, 1997-1 C.B. 351 (QSUB election filed on Form 966).

The QSUB has its roots in REIT provisions allowing qualified REIT subsidiaries. See IRC § 856(i). See generally, Jerald D. August et al., *A Planning Guide to the Proposed Regulations on Qualified Subchapter S Subsidiaries*, supra note 54; Jerald D. August, *The New World of Controlled Subsidiaries Under Subchapter S*, 9 J. S Corp. Tax'n 3 (1997); Bryan P. Collins et al., *Qualified Subchapter S Subsidiaries: A Tax Planning Guide to the New Law*, 9 J. S Corp. Tax'n 219 (1998).

194. See Staff of Joint Comm. on Tax'n, 104th Cong., 2d Sess., *General Explanation of Tax Legislation Enacted in the 104th Congress* 120 (Comm. Print 1996). Although the General Explanation is not official legislative history, it indicates congressional intent as to a particular provision. Arguably, the statutory language adequately supports this conclusion without assistance from legislative history.

195. This provision was § 1361(b)(2) (before amendment by P.L. 104-188, § 1308(a), 110 Stat. 1755, 1782 (1996)).

196. See IRC § 1361(c)(2)(A)(v). In order to qualify as an ESBT (1) all beneficiaries of the trust must be individuals eligible to own S stock, estates, or charitable organizations, (2) no interest in the trust may have been acquired by "purchase," and (3) an election must be made by the trustee as prescribed in the regulations. See IRC § 1361(e)(1).

trust, held the stock for only a short period after the death of the grantor, or was a "qualified Subchapter S trust" (generally, a simple trust with only one beneficiary, who elects to be taxed on all of the trust's income).¹⁹⁷ The peculiar feature of the ESBT rules is the treatment of the portion of the trust consisting of S stock as a separate taxpayer with respect to its allocable share of Subchapter S income.¹⁹⁸ An ESBT is taxed on its S income at the maximum rate of tax on individuals, subject to the special rates for net capital gain. Trust distributions from S income are nontaxable to the beneficiaries and nondeductible by the trust. The normal rules of Subchapter J, including carryovers and excess deductions in the trust's final taxable year,¹⁹⁹ apply to the trust's other income and deduction.

The Treasury presumably endorsed the ESBT model because tax could be charged and collected from a single source—the trust. If Subchapter J had applied to the accumulation trust and shareholder, the trust could have allocated the incidence of tax between the trust and the beneficiary in order to minimizing tax.²⁰⁰ By taxing the ESBT's share of S income at the highest individual rate, the rules eliminate all bracket shifting opportunities.

The design and effect of ESBTs bear a striking resemblance to the "comprehensive business income tax" (CBIT) proposed by the Treasury in its corporate integration study of 1992.²⁰¹ The CBIT regime, which would apply to all businesses regardless of size or form of organizational, would impose an entity level tax on its taxable income, computed without deductions for interest expense and whether the income was distributed or not, and distributions and interest payments would be exempt from tax to the owners and creditors. A major goal of the CBIT is to remove the bias in favor of debt over equity under current law under Subchapter C.

197. See IRC § 1361(c)(2)(A). For the definition of qualified subchapter S trust, see § 1361(d).

198. See IRC § 641(d). Each potential current beneficiary of the trust is counted as one shareholder for purposes of the 75-shareholder ceiling; if there are no potential current beneficiaries, the trust is treated as the shareholder. See Jerald D. August, *Recent Regulations Clarify Use of QSSTs in Estate Planning*, 23 *Es. Plan.* 102 (1996).

199. See IRC § 642(h).

200. See IRC §§ 661-663 (distribution deductions for accumulation trusts); §§ 665-668 (excess accumulation distributions). See generally M. Carr Ferguson et al., *Federal Income Taxation of Estates, Trusts, and Beneficiaries* (2d ed. 1997).

201. Dep't of the Treasury, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992). See also Alvin C. Warren, Jr., *Reporter's Study of Corporate Integration, Integration of the Individual and Corporate Income Taxes*, 1993 A.L.I. *Income Tax Project* (1993). For analysis of the Treasury and ALI studies, 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); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 *Tax L. Rev.* 431 (1992).

V. WHY NOT REPEAL SUBCHAPTER S?

After 40 years of Subchapter S, especially after the CTB regulations and the wide use of LLCs and LLPs, the obvious question is whether we really need it? While many traps for the unwary were removed in 1982 and 1996, Subchapter S continues to be plagued by eligibility and operational impediments. These restrictions make the LLC and its partnership siblings better passthrough vehicles for business and investment activities. Since state law no longer determines an unincorporated entity's tax status, why not simplify the taxation of all passthrough entities into one regime? Indeed, the conduit rules of Subchapter K offer far greater structural and transactional flexibility, with the exception of an inability to engage in tax-free reorganizations, and also offer more income deferral techniques than Subchapter S.

Moreover, in not providing Subchapter S corporations with the same organizational flexibility as partnerships—by, for example, prohibiting nonresident alien shareholders and preferred stock—Congress has restricted S corporations and their shareholders in their access to capital. Although these defects may sometimes be avoided by using a joint venture including one or more S corporations,²⁰² this structure results in greater transactional and compliance costs and rewards the more sophisticated business owners over the less sophisticated. Ideally, Subchapter K should be the paradigm passthrough model for all private business firms.

In a world without Subchapter S, business entities might be grouped into two categories, entities with ownership interests readily tradeable on established securities markets and all other business entities.²⁰³ Publicly traded enterprises would always be taxed as C corporation, as under current law, while all nonpublicly traded business enterprises would be taxed as partnerships under Subchapter K. Although this simplification of the taxation of business entities has broad conceptual appeal, it could be considered seriously only if very liberal transitional rules were enacted to reduce the tax cost of converting from C to K or S to K status.

A. *Conversions to Subchapter S or Subchapter K: The Practical Barriers*

The tax cost of converting a C corporation to a partnership is often very high because the conversion is treated as a corporate liquidation, causing the corporation to be taxed on unrealized gains in its assets and the

²⁰². See Rev. Rul. 77-220, 1977-1 C.B. 263, revoked by Rev. Rul. 94-43, 1994-2 C.B. 198; see Regs. § 1.701-2(d) ex. 2.

²⁰³. This was the baseline proposal in a draft of an ALI study on passthrough entities. See George K. Yin & David J. Shakow, Memorandum No. 3, Taxation of Private Business Enterprises, 1997 A.L.I. Fed. Income Tax Project (1997).

shareholders to be taxed on the gains on their shareholdings.²⁰⁴ The combined effective federal rate may be as high as 48% (corporate tax of 35%, plus shareholder capital gains tax of 20% of 65%). Including state taxes, the tax cost of a liquidation can exceed 60%. Because of this lock-in problem, unincorporated business enterprises that have always been subject to Subchapter K enjoy a competitive advantage over incorporated firms. The older the corporation, the greater the possibility that it has a successful track record, producing substantial appreciation in intangibles, including goodwill and going concern value, or assets such as improved real estate. This locked-in aspect of operating a veteran business in corporate solution hits hardest and most inequitably on owners of closely held corporations.

The only viable escape route is to convert to Subchapter S. But as mentioned, this path is often littered with formidable obstacles, including recapture of the spread between LIFO and FIFO inventory, the ten-year application of section 1374, or the tax on excess passive investment income. Eligibility restrictions must also be satisfied, perhaps requiring preconversion redemption of an ineligible shareholder or repayment of hybrid debt. The cost associated with a C to S conversion is frequently too high.

Sophisticated planning techniques have been offered to move around these handicaps. For example, a corporation, C or S, faced with double taxation but hoping to benefit from Subchapter K, can contribute one or more lines of its business to an LLC or LP whose remaining equity interests are held by shareholders.²⁰⁵ The corporation receives back a preferred interest with a reasonable redemption privilege, while the shareholder-partners receive common interests and are allocated the growth.²⁰⁶ The partnership contribution transfer is generally nontaxable,²⁰⁷ although section 704(c) precludes shifting pre-contribution gains and losses away from the contributing partner. Overall, the plan should not be vulnerable under the partnership anti-abuse rules.²⁰⁸

Another method for mitigating the second round of taxation is to find a deductible source for making cash payments to shareholders, such as

204. IRC §§ 331(a), 336(a). Section 336(d) sets forth exceptions to loss recognition, including anti-stuffing rules.

205. Frequently such transactions are partially motivated by estate planning concerns, such as making gifts of the limited partnership or LLC member interests to trusts for the benefit of children or grandchildren. There is also the sweetener of a § 754 election to step-up the value of any retained partnership interests included in the estate of a deceased partner (and shareholder). Donative transfers of partnership interests must also be placed under the lens of the family partnership rules of § 704(e).

206. For controlled family entities, the Chapter 14 quartet of valuation rules for transfer tax purposes must be consulted.

207. See IRC § 721(a). But see IRC §§ 707(c), 731, 751(b).

208. See Regs. § 1.701-2.

bonuses, deferred compensation, or the leasing of real or personal property.²⁰⁹ A third option is to sell the corporation's assets to an LLC or LP comprised of the shareholders. The transaction may be structured as an installment sale in order to defer the corporate tax, but the parties' expectations are often frustrated by various statutory tools available to the Service.²¹⁰ A more daring and risky approach is to form a new entity as an LLC or LP and shift future business opportunities to it while phasing down the corporation's business operations. The latter technique is burdened by a risk that the steps will be collapsed and treated as a deemed distribution of intangibles to the shareholders.²¹¹

Notwithstanding the possible methods for limiting the impact of double taxation prospectively, one may ponder why Subchapter S has not been given equal treatment with partnerships. Moreover, if all PBFs are to be taxed under Subchapter K, a C to K or S to K conversion should be allowed at a reasonable cost. Such cost should not be a full round of double taxation, which may approach or exceed 50% of the value of its equity.

B. Further Reforms to Subchapter S

Until we adopt a single system of taxation for private business enterprises, which, as suggested above, should carry with it liberal transitional relief for owners of C and S corporations, the disadvantages that S corporations face versus their partnership counterparts should be alleviated. Five reforms are suggested below that would produce a more equitable system of passthrough taxation for owners of incorporated and unincorporated PBFs.

1. *Reform I: Allow Nonresident Aliens to be Shareholders of an S Corporation.*—Given our global economy and existing structure of permitting nonresidents to be partners in partnerships, subject to applicable withholding

209. In order to be deductible, such payments must be ordinary and necessary and reasonable in amount. See IRC § 162(a); see also IRC §§ 263, 263A.

210. See IRC § 56(c) (corporate alternative minimum tax on increase in adjusted earnings and profits); § 168(f)(5) (antichurning rule for depreciation); § 197(f)(9) (antichurning rule for intangibles amortization); § 304(a)(1) (purchase of stock by related corporation taxable as a dividend); § 312(n)(5) (installment sale gain included in earnings and profits for year of sale); 368(a)(1)(F) (mere change in identity, form, or place of organization of one corporation is a reorganization); § 446(b) (Service's power to require adjustments to clearly reflect income); § 453(e) (acceleration of installment obligation on second disposition of purchased property by related person-buyer); § 453(g) (denial of installment sale treatment of depreciable property by related persons unless tax avoidance is not one of the principal purposes of the transaction); § 482 (reallocation of items between commonly controlled trades or businesses); § 1239(a) (recharacterization of gain from any depreciable asset as ordinary).

211. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

under section 1446, it is long overdue that nonresident aliens should be entitled to own stock interests in an S corporation.²¹²

2. *Reform II: Allow an S Corporation to Issue Plain Vanilla Preferred Stock.*—To reduce a major advantage of partnerships over S corporations, an S corporation should be permitted to issued preferred stock closely resembling debt without terminating its S status.²¹³ This preferred stock should be required to be (1) nonvoting, (2) limited and preferred as to dividends, (3) not participating in corporate growth to any significant extent, and (4) entitled to redemption and liquidation rights not in excess of the issue price plus a reasonable redemption or liquidation premium. The preferred shareholders would not be treated as shareholders and could be persons otherwise ineligible to own the S stock. Unless made in redemption, distributions on the preferred stock would be treated as interest income of the holder and deductible to the corporation when paid. This last feature would remove potential allocation and timing problems.

3. *Reform III: Further Expansion of Straight Debt.*—Since 1996, straight debt, as defined under section 1361(d), can be held by any individual (other than a nonresident alien), an estate or trust that is permitted to be an S shareholder, or a person actively and regularly engaged in the business of lending money. Based on Reform I, which would permit nonresident aliens to be S shareholders, the straight debt safe harbor should also be opened to nonresident aliens. Also, convertible debt cannot presently qualify as safe harbor debt. This impedes an S corporation's ability to obtain venture capital and other forms of financing available to other passthrough entities.²¹⁴ The proscription on the convertibility of straight debt should be lifted in instances where the convertible feature is held by a person that is actively and regularly engaged in the business of lending money and is issued in connection with a commercially reasonable loan to the corporation.

212. For a discussion of the existing limitations, see *supra* text accompanying notes 29-34.

213. See *supra* text accompanying notes 155-156.

214. Convertible debt may be a prohibited second class of stock if (1) the instrument is equity under general principles of federal tax law and a principal purpose of issuing the instrument is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding stock or to circumvent the limitation on eligible shareholders, or (2) the convertible debt contains rights equivalent to an in the money call option. Regs. §§ 1.1361-1(f)(4)(iv). However, a call option is not a second class of stock if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. Regs. § 1.1361-1(f)(4)(iii)(B).

4. *Reform IV: Repeal Termination Rule for Excess Passive Investment Income.*—Section 1362(d)(3) terminates an S corporation's election if it has C earnings and profits and receives excess passive investment income for three consecutive S years. The tax on passive investment income under section 1375 is a sufficient sanction for passive corporations seeking to convert from C to S status. The termination rule should be repealed.

5. *Reform V: Repeal Section 752 for Partnerships.*—An S shareholder has basis only to the extent that he or she has made an "actual economic outlay."²¹⁵ Under section 1366(d), an S shareholder's pro rata share of corporate losses is deductible only to the extent of the shareholder's basis in stock and debt. In contrast, partners are able to include their shares of partnership indebtedness in the bases of their partnership interests. Normally, partners share partnership liabilities according to their economic exposure to the liabilities, but if no partner is personally liable for the repayment of a partnership obligation, the liability is shared by all partners, including limited partners or LLC members, in proportion to their profit shares.²¹⁶

Other than historical precedent, which is rooted in the aggregate theory of partnership taxation, there is no persuasive justification for permitting partners to increase basis for entity level debt. Any rationale that might be offered becomes tenuous as applied to nonrecourse debt. In most instances, owners of a closely-held business enterprise must personally guaranty financing to the business. Such guarantees do not increase basis of S shareholders, but the guaranteed debt is included in partner basis. Partner basis benefit also facilitates tax-free distribution of cash flow to the partners. A partner's ability to receive tax-free distributions of funds from refinancings and to deduct depreciation on debt-financed property is unavailable to S shareholders. Partners should not be allowed to increase basis for nonrecourse debt. Were Congress to repeal the partnership debt rules, consideration could also be given to repealing the at risk and passive activity loss limitations of sections 465 and 469.²¹⁷

215. *Raynor v. Commissioner*, 50 T.C. 762 (1968). But see *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985).

216. See Regs. § 1.752-1.

217. It was always difficult for this author to understand why an investor was not permitted under § 469 to deduct losses to the extent of cash invested, simply because the investor did not actively participate in the venture. The repeal of § 752 might persuade Congress that it overshot the mark in enacting § 469.

VI. MOVING TOWARDS A SINGLE REGIME OF TAXING PRIVATE BUSINESS ENTERPRISES

Professor Yin, in his excellent article published in this issue, endorses the concept that all PBFs, regardless of organizational form and state law characteristics, should be taxed as partnerships under a two track elective system.²¹⁸ Under his proposals, the present complex partnership provisions would continue to apply to most PBFs, but some (SPBFs) would be eligible to elect a second, simplified system, which would be available only if all of the entity's owners were eligible to own stock under present S rules. Under the SPBF system, allocations of income and deduction would generally be in proportion to the owners' percentage interests. Preferred interests, which would have varying priorities as to repayment and claims on assets, would be permitted under a cash method system of income to the payee and income reduction to the payor. The present liability rules under section 752 would apply.

Contributions to an SPBF would be handled similarly to the treatment under section 351, except that there would be no control requirement. Section 704(c) would not apply to SPBFs, removing much complexity. SPBF owners would recognize gain on nonliquidating distributions to the extent that the value of the distribution (including cash) exceeds the basis of the distributee's ownership interest, but no loss would be recognized. A liquidating distribution would be treated as a sale or exchange of the ownership interest. The entity would recognize gain on distributing appreciated property unless the distribution effected a "mere change in form," as such phrase would be defined, subject to an election out. Entity recognition of gain on distributions in kind would render unnecessary numerous antishifting rules of Subchapter K. The collapsible asset rules of section 751 and section 341 would not apply to SPBFs. Section 754 is also outside of the SPBF system.

The idea of taxing all PBFs under a single tax system has strong appeal. It recognizes that present law imposes unfair burdens and detriments on corporations and their shareholders. The earnings of a C corporation are potentially subject to double taxation, and a C corporation PBF is thus faced with trying to avoid a second round of taxation. The Subchapter S restrictions and C to S conversion problems strongly advantage the partnership over S status. So, should all PBF's be taxed as partnerships? Professor Yin answers this question in the affirmative, but he proposes a two track system—keeping Subchapter K in place for PBFs while allowing some PBFs to elect a simplified version of Subchapter K.

218. See generally Yin, *supra* note 1.

This author believes that all PBFs should be taxed under a single system. A two-system partnership world retains the complexity of present law, needlessly interjects elective rules, and would produce a new set of imponderables. Particularly troublesome would be electing-in and electing-out strategies and outcomes for PBFs that are advantaged by moving back and forth from the more complex default system.

The two system proposal does recognize, however, that the present law governing the taxation of partnerships is strongly favored by many sectors of our business and investment communities. The ability to make special allocations and have debt, even nonrecourse debt, reflected in outside basis are significant factors in the use of partnerships. However, the complexity of the partnership rules, especially in tracking and adjusting capital accounts, detracts from its usefulness as the passthrough paradigm for all PBFs. In many instances, highly sophisticated tax professionals disagree on the proper treatment under present law of special allocations, gain chargebacks, negative capital accounts, and the application of section 704(c), producing much uncertainty and potential for abuse. Many provisions of Subchapter K are frequently overlooked or ignored. Decisions on proper tax reporting are often made subjectively, based on an accountant's sense of fairness or equity.

Subchapter K, despite its flexibility, is too complicated, and it should be streamlined as far as it can be without significantly compromising the basic goal of taxing entity income to its beneficial owner. These simplifications should include, for example, disallowing special allocations, removing nonrecourse debt from outside basis, and taxing nonliquidating distributions of appreciated property.

This author's preference is to select the entity, not the individual investor, as the proper taxpayer for PBFs. Although an entity tax does not directly fall on the beneficial owner of the income, it is imposed on the person that realizes the profits. The Treasury's CBIT model, with the basis add-on DRIP, is a good alternative. It is administratively manageable because compliance and audit issues would be resolved at the entity level.

How does Subchapter S fit within the PBF debate? Those who do not favor the CBIT proposal can agree that Subchapter S taxes the right person—the shareholder. Subchapter S is less flexible than Subchapter K, but it is much simpler and straightforward. It does not permit special allocations. It does not suffer from Byzantine rules for maintaining capital accounts. It properly differentiates between owner debt and entity debt. Unlike a partnership, an S corporation can be a party to a tax-free reorganization. If Subchapter S were to apply to unincorporated PBFs, the reorganization rules could be extended to encompass them. A super Subchapter S, which removes many of the present restrictions on owner eligibility and permits the issuance of simple preferred stock, could satisfy the objectives of entity parity,

fairness, and simplification and be a far superior means of conduit taxation than present law.