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Integrating Subchapters K and S— Just Do It

WALTER D. SCHWIDETZKY*

I. Introduction

The Code contains two “pass-through” tax regimes for business entities. One is contained in Subchapter K, which applies to partnerships, the other in Subchapter S, which, unsurprisingly, applies to S corporations. In the main, both Subchapters tax the owners of the entities rather than the entities themselves. Having two pass-through tax regimes creates obvious administrative and other inefficiencies. There was a time when S corporations served a valuable purpose, particularly when taxpayers needed a fairly simple and foolproof pass-through entity that provided a liability shield. But limited liability companies (LLCs), which are usually taxed as partnerships,¹ in most contexts make S corporations obsolete. LLCs too can be fairly simple and foolproof, while providing the superior tax benefits of the partnership provisions of Subchapter K.² The advent and popularity of LLCs means that the inefficiency created by two separate pass-through tax regimes can no longer be justified. I propose that a new pass-through regime be created that retains Subchapter K and incorporates the best parts of Subchapter S, with the balance of Subchapter S repealed. Integrating these two pass-through regimes requires that some changes be made to the C corporation provisions of Subchapter C as well. I also make Subchapter K available to most nonpublic C corporations, putting most closely held businesses on a level playing field.

It has been difficult to justify Subchapter S for some time. In 1996, I published an article recommending the repeal of Subchapter S.³ In a rather novel experience for a law professor, in 2004 there was a bill in the House of

*Professor of Law, University of Baltimore, School of Law; I would like to thank Professor William Lyons of the University of Nebraska College of Law, Professor Fred Brown of the University of Baltimore School of Law, Professor Sean M. O'Connor of the University of Washington School of Law, the participants at the 2008 Washburn University School of Law Partnership Tax Symposium, and the participants in the tax meetings of the 2008 Law and Society Conference (organized by Professor Neil Buchanan of George Washington University School of Law) for their decidedly helpful comments. This Article was written with the benefit of a research stipend from the University of Baltimore School of Law, for which I am grateful.

¹ See *infra* text accompanying notes 10–18.

² See *infra* text accompanying notes 62–104.

³ Walter D. Schwidetzky, *Is It Time To Give The S Corporation A Proper Burial?*, 15 VA. TAX REV. 591 (1996) [hereinafter S Corp. Burial]. I draw freely from that article in writing this one.

Representatives that would have, among other things, enacted my proposal.⁴ The bill, however, never became law and the tax system remains saddled with both tax partnerships and S corporations.

The tax universe today is very different from that of 1996. I continue to believe that Subchapter S should be repealed. It remains inefficient to have two pass-through tax regimes, and the repeal of Subchapter S is much more politically realistic than the repeal of Subchapter K, and indeed, perhaps more realistic today than it was in 1996. But there is also much additional grist for the mill, and, with a little prodding from some colleagues, I am reexamining the area. I am encouraged in my efforts by the fact that business entity tax reform is receiving heightened attention in Congress.⁵

S corporations offer a number of legitimate benefits not currently available to tax partnerships and those benefits should be incorporated into Subchapter K. Many of these benefits have come to the fore since my 1996 article. Some derive from the simple fact that the S corporation is a corporation. For example, parties who anticipate a public offering often use an S corporation, as it is a simple matter to convert it to a C corporation prior to the public offering. Employee Stock Option Plans, which by definition can only own corporate stock, often own stock in S corporations. S corporations are often preferred by the venture capital industry. The hope is that the S corporation will be able to make a public offering of its stock, or that the S corporation will become the target of a friendly takeover by a public corporation. Those takeovers are much easier to structure on a tax-friendly basis if the target is a corporation. How can the needs of the parties making these and similar uses of S corporations be met in a world without Subchapter S? The solution I propose is to make it easier for partnerships to incorporate than is currently the case.

Another benefit of S corporations is the so-called "capital gain freeze" where taxpayers sell real property to an S corporation to "freeze" existing long-term capital gains before developing the property. I recommend that a comparable benefit be made available in Subchapter K.

The changed tax and business environment cause me to recommend a bolder, more comprehensive approach than that which I recommended in my 1996 article. As noted above, I now recommend that almost all nonpublicly traded corporations be allowed to elect to be taxed under Subchapter K. Closely held businesses should at least have the option of playing on the same field.

S corporations are also often used to improperly reduce or eliminate Social Security and Medicare taxes. The elimination of S corporations will, of course, end this abuse.

⁴Small Business Modernization Act of 2004, H.R. 4137, 108th Cong. (2004) [hereinafter H.R. 4137].

⁵See J. COMM. ON TAX'N, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF BUSINESS, (Comm. Print 2008), *available at* <http://www.house.gov/jct/x-48-08.pdf> [hereinafter JCX-48-08].

But the repeal of Subchapter S will make more acute a problem that currently exists with the Social Security and Medicare tax provisions. These taxes are meant to apply to income from services, but the current rules may over- or understate the applicable tax liability. In conjunction with any business entity tax reform, Congress must more clearly address when income is from services (and thus subject to these taxes) and when income is from capital (and thus not so subject). I recommend that, aside from portfolio income, all income of partnerships that are primarily engaged in the performance of services be subject to Social Security and Medicare taxes. For capital intensive partnerships, on the other hand, I recommend that partners be required to be paid reasonable compensation for their services, and that only this compensation be subject to Social Security and Medicare taxes.

Part II of the Article discusses the tax entity selection process generally, as well as the basics of the taxation of C corporations, S corporations, and partnerships. Part III explores the tax advantages and disadvantages of partnerships and S corporations. Part IV looks at the data on the relative popularity of the major business entities and provides a possible explanation for the continued popularity of S corporations. Part V discusses H.R. 4137, a bill that was ahead of its time (and not unflawed). Part VI asks whether we should repeal Subchapter K instead. Part VII recommends that nonpublic corporations also be allowed to elect Subchapter K. Part VIII proposes taxpayer-friendly methods for getting to my version of the promised land, and Part IX gives a brief conclusion.

II. Context

A. *Tax Entity Pigeon-Holing*⁶

As a general principle, for federal tax purposes, businesses have three entities from which to choose: The C corporation, the S corporation, and the tax partnership. State law corporations are always classified as corporations for federal tax purposes (C or S).⁷ State law unincorporated business entities, on the other hand, might be classified as any of these three entities for federal tax purposes (or if they have a single owner, simply be disregarded for federal tax purposes).⁸ Thus, a partnership for federal tax purposes may be something very different for state law purposes. The ubiquitous example is the LLC,⁹ which is not a partnership for state law purposes, but typically is a partner-

⁶For those with tax expertise, what follows belabors the obvious. Think of it as outreach to rookies and foreign cross-trainers.

⁷Reg. § 301.7701-2(b)(1).

⁸See Reg. § 301.7701-3. Of course, an individual doing business alone, and not through an entity, conducts business as a sole proprietorship, but that is not normally thought of as a separate entity. Since it lacks any type of liability shield, it is also usually an unintelligent choice. Further, there are what might be called special-use entities that operate outside this universe. Examples include regulated investment companies, better known as RICs or mutual funds, and real estate investment trusts, better known as REITs. See I.R.C. §§ 851, 856.

⁹A less ubiquitous example is the business trust.

ship for federal tax purposes. These differences between state law classification of business entities and federal tax law classification of those entities prompt use of the somewhat awkward term “tax partnership.” To the extent possible, I will avoid this awkward term. In general, when I refer to a partnership, I mean an entity treated as a partnership for federal tax purposes.

Tax classification of entities has a long, at times combative, and often tedious history.¹⁰ The Service finally grew weary of the effort it had to expend on tax classification issues, and quite sensibly came out with the “Check the Box Regulations” in 1996, which dramatically simplified things.¹¹ An eligible, unincorporated state law entity generally may choose its status for federal tax purposes.¹² If the “eligible entity”¹³ makes no election, it is disregarded for federal tax purposes if it has a single member (making it thus a “disregarded entity”),¹⁴ and it is taxed as a partnership if it has two or more members.¹⁵ Alternatively, the entity may “check the box,” that is, elect to be taxed as a C corporation or, if it meets the qualifications, an S corporation.¹⁶ It would be out of the ordinary for an entity to check the box to be taxed as a C corporation,¹⁷ and somewhat unusual to check the box to be taxed as an S corporation, inducing some to say it makes more sense to call them the “Don’t Check the Box” Regulations.¹⁸

¹⁰ See BORIS BITTKER & JAMES EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, § 2.01-2.04 (2000) [hereinafter BITTKER & EUSTICE].

¹¹ Simplification of Entity Classification Rules, 61 Fed. Reg. 66584 (Dec. 18, 1996) (to be codified at 26 C.F.R. pt. 1); Reg. § 301.7701-1 to -3.

¹² Reg. § 301.7701-3(a), -3(b)(1). There are a number of exceptions. Insurance companies, banks, entities owned by a state or a political subdivision of a state, and entities taxable as corporations under provisions of the Code other than section 7701(a)(3) are taxed as C corporations. See Reg. § 301.7701-2(b). My focus here is on state law, *i.e.* domestic entities. The rules are different for foreign entities. See Reg. §§ 301.7701-2(b)(8), -3(b)(2).

¹³ An eligible entity is an entity that is *not* classified under the Regulations as a corporation. See Reg. 301.7701-3(a). Actual state law corporations are classified as corporations for federal income tax purposes. Other per se tax corporations include insurance companies and certain banks (though they typically also operate using a state law corporation). See Reg. § 301.7701-2(b).

¹⁴ If the sole owner of the eligible entity is an individual, for tax purposes the entity is treated as a sole proprietorship. If the sole owner is a corporation, the entity is treated as a division or branch of the corporation. See Reg. § 301.7701-3(b).

¹⁵ *Id.*

¹⁶ Reg. § 301.7701-3(c).

¹⁷ But it is not unheard of. Indeed, if one prefers to be a C corporation, it can make sense to form a state law LLC rather than a state law corporation and check the box. LLCs commonly have more modern “statutory architecture,” meaning they are more flexible and have a lesser reporting burden than corporations. See CARTER BISHOP & DANIEL KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* § 1.02 [hereinafter BISHOP & KLEINBERGER].

¹⁸ See, *e.g.*, *LIMITED LIABILITY COMPANY HANDBOOK* § 3 (Mark Sargent & Walter Schwidetzky eds., 2008).

B. C Corporations

C corporations are not beloved because they are subject to two levels of tax. The C corporation is subject to a tax on its income at the corporate level,¹⁹ and when the C corporation pays dividends, the shareholders who receive them are taxed again, typically at a 15% rate.²⁰ A distribution is only a dividend to the extent of a C corporation's "earnings and profits."²¹ Earnings and profits, to put it very roughly, are undistributed net earnings of a C corporation.²² A contribution of property to the C corporation in exchange for stock is not taxable to the corporation under section 1032, but is a fully taxable exchange to the contributing shareholders unless the shareholders transferring the property have control of the corporation immediately after the transfer, defined, to oversimplify a bit, as 80% of the stock.²³ If a C corporation makes a nonliquidating distribution of assets to its shareholders, it must recognize any gain inherent in those assets at the corporate level, but is denied any such loss.²⁴ If it is a liquidating distribution, gains are recognized and losses may be recognized by the C corporation.²⁵ On liquidation, shareholders generally recognize a capital gain or loss based on the difference between the money and fair market value of what is received and the basis in their stock, again assuring two levels of tax. In either a nonliquidating or liquidating distribution, the recipient shareholder takes a fair market value basis in the distributed property.²⁶

One might think that no one in his right mind would ever use a C corporation and indeed, most right-minded people do not. But there are exceptions, three of which deserve to be highlighted. Publicly traded entities normally are taxed as C corporations, so a business planning a public offering, especially

¹⁹ See I.R.C. § 11.

²⁰ See I.R.C. § 1(h)(11). If you want more detail, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.01-8.05. A dividend received deduction is available to corporate shareholders under section 243.

²¹ See I.R.C. §§ 301(c)(1), 316. Distributions in excess of earnings and profits generally recover basis and then are treated as gain from the sale of the underlying stock. See I.R.C. § 301(c)(1)-(2).

²² Numerous special calculations apply. See BITTKER & EUSTICE, *supra* note 10, ¶ 8.03-9.04.

²³ I.R.C. §§ 351(a), 368(c). Specifically, the owners must own stock (previously held or received on the exchange) possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c).

²⁴ I.R.C. §§ 301(d), 311. The gains increase earnings and profits. Reg. § 1.312-7(b)(1).

²⁵ See I.R.C. § 336(a). Losses inherent in distributed corporate assets may only be recognized on a liquidating distribution, and then there are limits. See I.R.C. § 336(d). The recipient shareholder takes a fair market value basis in the property received. I.R.C. § 334(a). Gain or loss is generally not recognized on the liquidation of a corporate subsidiary and the corporate shareholder takes a carryover basis in the assets. See I.R.C. §§ 332, 334(b).

²⁶ I.R.C. §§ 301(d), 334(a).

an immediate one, might form a C corporation from the outset.²⁷ It might also select an S corporation and then switch to C corporation status, as I discuss below. C corporations often are preferred in international transactions. Foreign countries may find it difficult to classify, and indeed may be completely flummoxed by, U.S. tax partnerships such as LLCs.²⁸ Further, and more importantly, many tax treaties that the U.S. has with foreign countries give preferential treatment to dividend payments, making the C corporation (the only entity capable of paying a dividend) a rational choice for a U.S. business's foreign activities.²⁹ The sometimes awkward operation of the U.S. branch profits tax also can make U.S. C corporation subsidiaries preferable for the U.S. business activities of many foreign corporations.³⁰ Finally, one might select a C corporation for an extra "run up" the tax brackets. Under section 11, the rates of tax on C corporation taxable income range from 15% on the first \$50,000 and 25% on the next \$25,000 up to 35% on income over \$10 million.³¹ The maximum individual income tax rate is 35% under section 1(i). A taxpayer whose marginal tax rate is 35% might be tempted to collect additional income in a C corporation to take advantage of the lower corporate rates, especially on taxable income up to \$75,000. There are Code sections that would get in the way of serious abuse in this regard, including a flat tax rate of 35% for personal service corporations in section 11(b)(2), the accumulated earnings tax of section 531, and the personal holding company tax of section 541. But minor game playing, which in the aggregate may cost

²⁷ A publicly traded partnership is normally taxed as a C corporation, though there is an exception for publicly traded partnerships 90% or more of whose income is from certain passive sources. See I.R.C. § 7704.

²⁸ For the German take on limited liability companies, see generally Helmut Krabbe, *Steuerliche Einordnung der nach dem Recht der Bundesstaaten der USA gegründeten Limited Liability Company*, 10 INTERNATIONALE STEUERRECHT [ISTR] 351 (2004); Christiana Djanani, et al., *Die Einordnung der LLC nach innerstaatlichem deutschen und US-amerikanischen Steuerrecht*, 14 INTERNATIONALE STEUERRECHT [ISTR] 481 (2004).

²⁹ See, e.g., Convention Between the United States and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-F.R.G. art. 10(2), Aug. 29, 1989, 5 U.S.T. 2768. An outbound transaction is one in which a U.S. taxpayer invests outside the United States.

³⁰ The U.S. corporate subsidiaries are always C corporations as corporations and nonresident aliens cannot be shareholders of an S corporation. See I.R.C. § 1361(b). For a discussion of why a foreign corporation would prefer to operate with a U.S. corporate subsidiary rather than a branch, see generally Fred Brown, *Reforming the Branch Profits Tax to Advance Neutrality*, 25 VA. TAX REV. 1219 (2006).

³¹ The rate goes to 34% for taxable income above \$75,000 but not exceeding \$10 million, and 35% for taxable income over \$10 million. The benefit of the graduated rates below 34% are phased out for corporations with taxable income between \$100,000 and \$335,000, and the 34% rate is phased out for corporations with taxable income over \$15 million. See I.R.C. § 11. Note that the application of section 199 can result in a lower effective tax rate. The tax rate on dividends paid to individuals is generally 15%. See I.R.C. § 1(h)(11).

the fisc dearly, is possible and is reported to take place.³²

Lest I leave the novice reader with the impression that all C corporation users are stuck with a double tax, let me quickly add that this is far from necessarily the case. C corporations often seek to “zero out” their income by, among other things, paying deductible salaries to shareholder-employees, paying deductible interest to shareholder-creditors, and paying deductible rent to shareholder-landlords. Many a lawyer has become enriched doing battle in court over what counts as a reasonable salary, a reasonable amount of debt, or a reasonable amount of rent.³³ Further, the deductibility of interest when contrasted with the nondeductibility of dividends can encourage a C corporation to have an excessively debt-heavy financial structure.³⁴

The relatively new tax rate on dividends of 15%³⁵ sometimes stands the corporate tax world on its head. Salary, interest income, and rents are all taxed at ordinary income rates of up to 35%. It can make more sense to pay a non-deductible dividend than, for example, a deductible salary to a shareholder-employee, especially for C corporations with low marginal income tax rates that have shareholders with high marginal rates. This change of pace is utterly counterintuitive to battle-hardened tax veterans.

C. S Corporations

S corporations were in many respects designed with the smaller business in mind, though there is no dollar limit on their size, and many are quite sizeable with numerous employees.³⁶ An S corporation is a pass-through entity. Generally, there is no corporate level tax. Instead, to recite the statutory litany, income, gain, loss, deduction, and credit of the S corporation flow through to, and are taken into account by, the shareholders, retaining the character they had at the corporate level.³⁷ Allocations of these items to the shareholders are based on shareholders' percentage of stock holdings.³⁸ An S corporation is subject to the Subchapter C rules for property contributions and distributions. Thus, a contribution of property to the S corporation in

³² See John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 995 (1999).

³³ See BITTKER & EUSTICE, *supra* note 10, § 8.05.

³⁴ See I.R.C. § 163(a); *see generally*, U.S. DEPARTMENT OF TREASURY, OFFICE OF TAX POLICY, *APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY* (Dec. 20, 2007). In one of the more hilarious chapters of tax history (yes, it is possible for tax to be funny), Congress in 1969 enacted section 385, authorizing the Service to issue regulations defining debt and equity. The Service tried early on, got shot down, and has not worked up the nerve to try again since. Some 40 years have gone by since the enactment of section 385, and we are still waiting for the regulations (not that many tax advisors want the Service to work up that nerve). See James Eustice, *'Debt-Like' Equity & 'Equity-Like' Debt: Treasury's Anti-Hybrid Proposals*, 71 TAX NOTES (TA) 1657, 1657 (June 17, 1996).

³⁵ See Jobs and Growth Tax Relief Act of 2003, Pub. L. No. 08-27, 117 Stat. 752 (2003).

³⁶ See BITTKER & EUSTICE, *supra* note 10, § 6.01.

³⁷ See I.R.C. § 1366.

³⁸ I.R.C. § 1377(a).

exchange for stock only goes untaxed if the contributors meet the 80% control test of section 351(a) immediately after the contribution.³⁹ Further, the S corporation recognizes gain (which normally goes untaxed at the corporate level and flows through to shareholders along with other corporate income) when it distributes appreciated property to shareholders.⁴⁰ Losses inherent in distributed property may only be recognized in a liquidating distribution, and then limitations apply.⁴¹

Generally, a shareholder's share of the S corporation's income increases her basis in her stock, and losses and distributions reduce that basis.⁴² Losses may only be deducted to the extent of the stock basis and any basis in debt the corporation owes the shareholder.⁴³ Unused losses may be carried forward indefinitely.⁴⁴ Distributions generally are not taxable to the shareholder unless the amount of money and fair market value of property distributed exceed the shareholder's stock basis. The excess is viewed as gain from the sale of the stock.⁴⁵

This rather pleasant state of affairs changes if the S corporation has previously been a C corporation or been combined on a tax favored basis (*i.e.* without being fully taxed) with a C corporation. As long as it meets the qualification requirements, there are no restrictions on a C corporation becoming an S corporation. Further, the reorganization rules of section 368 apply to S corporations. Thus, for example, it is possible for a C corporation to merge tax free into an S corporation.⁴⁶

An S corporation does not ordinarily pay dividends. That is the province of C corporations. Only a C corporation can generate earnings and profits.⁴⁷ An S corporation can, however, inherit the earnings and profits of a C corporation if it was once a C corporation or if a C corporation merged into it.⁴⁸ If an S corporation has earnings and profits, it is possible for the S corporation to distribute a dividend which, like any dividend, is income to the recipient shareholder (and that thus does not fall under the distribution rules described above). To simplify a bit, an S corporation generally is considered to first make distribution of its own net earnings. Distributions in excess of its own net earnings generally come out of the earnings and profits, and thus constitute dividends and income to the shareholders, until the earnings and profits are eliminated.⁴⁹ Dividends do not affect shareholders' stock bases.⁵⁰

³⁹ I.R.C. §§ 351(a), 368(c); *see supra* text accompanying notes 22–25.

⁴⁰ I.R.C. § 311(b).

⁴¹ *See* I.R.C. § 336.

⁴² I.R.C. § 1367.

⁴³ I.R.C. § 1366(d)(1).

⁴⁴ I.R.C. § 1366(d)(2).

⁴⁵ I.R.C. § 1368.

⁴⁶ *See* I.R.C. § 368(a)(1)(A).

⁴⁷ *See supra* text accompanying notes 19–22.

⁴⁸ *See* I.R.C. § 381(a).

⁴⁹ *See* I.R.C. § 1368(c).

⁵⁰ *See* I.R.C. § 301(c).

Section 1374 applies a corporate level tax on the S corporation at the highest C corporation tax rate when the gains from certain assets are recognized. Covered assets are those held by the C corporation at the time it makes an S election or those that find their way from a C corporation into an S corporation on a tax favored basis, such as through a merger.⁵¹ Section 1374 ceases to apply ten years after the C corporation makes the S election or after an asset finds its tax favored way into S corporation solution.⁵² Additionally, section 1375 applies a corporate level tax at the highest C corporation tax rate to "excess net passive income"⁵³ if the S corporation has earnings and profits.⁵⁴ Passive income is income from sources such as dividends and royalties.⁵⁵ Generally, net passive income is gross passive income minus expenses to earn it and excess net passive income is net passive income in excess of 25% of gross receipts. In sections 1374 and 1375, Congress is clearly trying to preserve the double taxation attributable to the erstwhile C corporation.

The rules governing qualification as an S corporation also can present problems. These rules have been dramatically liberalized over the years, in part to make the S corporation more competitive with partnerships, but still provide very real limits on the use of S corporations. An S corporation may not have more than 100 shareholders⁵⁶ (as recently as 1995 it was 35 shareholders,⁵⁷ and in the early days it was ten shareholders⁵⁸), and may not have more than

⁵¹ See I.R.C. §§ 368(a)(1)(A), 1374(a), and 381(a); *see also* Reg. § 1.1374-1(e).

⁵² Further, the maximum gain subject to the section 1374 tax cannot exceed the net gain inherent in the C corporation assets at the time of the S election or at the time of the tax-favored transfer to the S corporation. The gain recognized under section 1374 on any individual asset cannot exceed the net gain inherent in it at either of those times.

⁵³ Essentially, passive investment income less the expenses to earn that income. See I.R.C. § 1375(b)(2).

⁵⁴ Distributions deemed to come out of earnings and profits are taxable dividends to the recipient shareholders. I.R.C. § 1368(c)(2).

⁵⁵ See I.R.C. §§ 1375(b)(3), 1362(d)(3).

⁵⁶ Actually, as members of a family can be treated as one shareholder, an S corporation can have thousands of shareholders, albeit ones that are related. See I.R.C. § 1361(c)(1)(A)(ii).

⁵⁷ I.R.C. § 1361(b)(1)(A) (1995).

⁵⁸ See I.R.C. § 1371(a) (1958).

one class of stock (though differences in voting rights are allowed).⁵⁹ There are rules for who may and who may not be S corporation shareholders. The "may not" group includes nonresident aliens, financial institutions that use the reserve method of accounting contained in section 585 (applies to many banks), insurance companies, corporations electing under section 936 (which allows credits for certain income from Puerto Rico), and Domestic International Sale Corporations (now something of an antique, as they have been held to violate the General Agreement on Tariffs and Trade).⁶⁰ The "may" group is limited to individuals, their estates, certain trusts (in general, voting trusts and trusts which are family oriented), qualified pension trusts, and section 510(c)(3) charitable organizations. Note that corporations (C or S) are not on the allowed list of shareholders, so generally a corporation may not own stock in an S corporation. There is one limited exception: an S corporation may own a qualified Subchapter S corporate subsidiary (QSSS), have the benefit of the subsidiary's liability shield for state law purposes, but have the subsidiary ignored for tax purposes, with all income and expenses flowing through to the parent.⁶¹ It often makes more sense, though, for the S corporation to use a wholly owned LLC, as there are fewer qualification requirements. There is no restriction the other way around, and an S corporation may own stock in a C corporation.

S corporations that once tangoed with C corporations have to be watch-

⁵⁹I.R.C. § 1361(b)(1), (2). A husband and wife and family members can be treated as one shareholder. See I.R.C. § 1361(c)(1)(A), (B). Often it is not clear why certain of the limitations on the use of S corporations were chosen. With regard to the one class of stock rule, however, there is a hint in the legislative history in this regard. The original drafters of subchapter S may have been concerned that the issuance of a class of preferred stock might have made it difficult to tax current earnings to shareholders. They may also have questioned how to tax dividends on preferred stock. See S. Rep. No. 83-1622, at 4667 (1954), which briefly discusses the complexities of having dividends on preferred stock in the context of a proposed bill that foreshadowed subchapter S. As the use of the S corporation accumulated adjustment account and the proposed S Corporation Reform Act of 1995 demonstrate, these problems are solvable. See I.R.C. § 1368(c)(1), (e)(1); see also JAMES EUSTICE & JOEL KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* § 7.06 [hereinafter EUSTICE & KUNTZ]; Curtis J. Berger, *Whether Partnership Taxation*, 47 TAX L. REV. 105, 141-43 (1991).

As with all corporations that borrow funds from their shareholders, there is a risk that this debt could be classified as equity, and thereby perhaps constitute the prohibited second class of stock. See BITTKER & EUSTICE, *supra* note 10, § 4.02. Section 1361(c)(5) provides some relief in this regard, providing that irrespective of the debt to equity ratio, "straight debt" will not be reclassified as equity. To qualify as straight debt, the debt must be payable on demand or at a date certain, generally the interest rate must not be contingent, the debt must not be convertible, and the creditor must be an individual, an estate, a trust that qualifies as an S corporation shareholder, or a commercial lender. See I.R.C. § 1651(c)(5)(B).

⁶⁰I.R.C. § 1361(b)(1)(C), (b)(2); see also Tax Understanding, Dec. 7-8, 1981, GATT B.I.S.D. 28S/114.

⁶¹I.R.C. § 1361(b)(3). Note that since an S corporation can own stock in other corporations, it can be part of an "affiliated group" (though outside of the QSSS rules, a corporation may still not be a shareholder). This was once prohibited. See EUSTICE & KUNTZ, *supra* note 59, § 3.06.

ful, but otherwise life is pretty good, or at least so it seems until the taxpayer learns of the advantages of Subchapter K. The grass is always greener. As I will discuss next, generally partnerships offer a still better tax deal than S corporations, but there are situations when S corporations have the upper hand. I will address these advantages after the partnership discussion.

D. Partnerships

Partnerships are also not subject to an entity level tax. Items of income, gain, loss, deduction, and credit flow through to, and are taken into account by, the partners, retaining the character they have at the partnership level.⁶² Taxable income increases a partner's basis in his partnership interest; deductible loss reduces that basis.⁶³ A partner may not deduct losses in excess of this "outside basis," though unused losses may be carried forward indefinitely.⁶⁴ Other pertinent details of partnership taxation follow.

Complexity is a large problem in the partnership tax arena. The partnership tax regime need not make the life of a given taxpayer complex, but it often does. As is not uncommon with tax law, there is tension between complexity and precision on the one hand, and administerability and taxpayer compliance on the other hand. Further, in a preview of things to come, that complexity can lead to abuses, in which case there can be complexity and imprecision, not the best of both worlds.⁶⁵

III. Advantages and Disadvantages of Partnerships and S Corporations

A. Advantages of Partnerships over S Corporations

Most tax professionals will affirm that on balance a partnership is, from a federal income tax perspective, superior to an S corporation. I now review the advantages. I intersperse a few S corporation advantages in this discussion when they are directly related to the partnership advantage for easier and more efficient understanding. These interspersed S corporation advantages are rarely, if ever, important enough to cause one to prefer an S corporation to a partnership. Those S corporation advantages that can make it the preferable vehicle I discuss separately below.

1. Contributions and Distributions

Tax-free contributions of property are more readily achieved using the partnership form. Normally, no gain or loss is recognized on a contribution of property to a partnership in exchange for a partnership interest.⁶⁶ There is no 80% threshold as there is with corporations, in fact there is no threshold at all.

⁶²I.R.C. § 702.

⁶³I.R.C. § 705.

⁶⁴I.R.C. § 704(d).

⁶⁵For an example of an abuse in this context, see Regulation section 1.701-2(d), ex. 9.

⁶⁶I.R.C. § 721(a).

If a partner makes a contribution of property to a partnership, under section 704(c)(1)(A), any gain or loss inherent in the property on contribution is taxed to the contributing partner when the partnership disposes of the property.⁶⁷ There is no analogy to section 704(c)(1)(A) in Subchapter S. Though a shareholder may make a tax-free contribution of property to an S corporation under section 351(a), upon disposition of that property, any inherent gain or loss is allocated to all of the shareholders based on their stock holdings.⁶⁸ Thus, a shareholder contributing appreciated property could, on a disposition of the property by the S corporation, effectively shift a portion of the gain to other shareholders.⁶⁹ As a consequence of that gain, the other shareholders could see their stock bases increase to an amount in excess of the fair market value of their stock. The other shareholders might not be able to take advantage of the loss inherent in the stock until the stock is sold, which could be well into the future. Further, the shareholders' recognized loss on the stock normally is a capital loss whereas the gain on the sale of the contributed property may be ordinary income, resulting in a character distortion in addition to a timing distortion. Finally, adding insult to injury, if a shareholder with a loss in his stock dies before disposing of the stock, he takes his loss with him.⁷⁰ The loss disappears because his heirs take a fair market value basis in the stock under section 1014.

The lack of an S corporation equivalent to section 704(c)(1)(A) can work to the benefit of shareholders who contribute appreciated property because the pre-acquisition gain is shifted to others, and to the disadvantage of shareholders who contribute money. The converse is the case if depreciated property is contributed. However, well-informed parties dealing at arm's length factor this issue into the allocations of stock to the shareholders. In a family context, where the parties are not dealing at arm's length, the lack of a section 704(c)(1)(A) analog may permit some income shifting amongst the shareholders. This can happen in a nonfamily context as well, where the shareholders to whom the gain is shifted have offsetting net operating loss carryforwards or are tax exempt. It seems unlikely, however, that given the other advantages of Subchapter K, that the lack of a section 704(c)(1)(A) analog drives many, if any, choice of entity decisions.⁷¹

In contrast to an S corporation, generally no gain or loss is recognized

⁶⁷There is a whole lot more to it than that. For example, tax depreciation generated by the property is allocated to the other partners to the extent of their shares of "book depreciation." Further, because section 704(c)(1)(A) by its terms can work imperfectly, Regulation section 1.704-3 provides three methods for applying it, the traditional method, the traditional method with curative allocations, and the remedial method.

⁶⁸I.R.C. § 1366(a).

⁶⁹The converse is the case if the property has an inherent, recognizable loss, but in that event the shareholder is more likely to sell the property and contribute the resulting cash.

⁷⁰As the heirs generally take a fair market value basis as of the date of death under section 1014, the loss is effectively eliminated. See I.R.C. § 1014.

⁷¹Section 1366(e) limits some abuse in the S corporation context. The partnership rule has a sounder tax and economic foundation.

when a partnership distributes property to its partners.⁷² Normally the recipient partner takes a carryover basis in the distributed property.⁷³ Obviously, the partnership rules are normally more favorable to taxpayers than the S corporation rules. Further, the tax cost of withdrawing property from an S corporation is often too high to justify the distribution. Current law prevents many S corporations from liquidating and converting to other forms of business enterprise, even if they would otherwise prefer to.

Sections 707(a)(2)(b), 704(c)(1)(B) and 737 contain complex rules designed to prevent taxpayers from using the tax-free contribution and distribution rules for partnerships to disguise what is in substance a taxable sale or exchange.⁷⁴ There is no analog in the S corporation provisions. Of course, in an S corporation it is more difficult to make a tax-free contribution, and any gain inherent in distributed property is recognized on distribution.⁷⁵ These disadvantages make a comparable anti-abuse rule for S corporations less necessary.

2. *Allocations*

A partnership is allowed to make "special allocations" to its partners. For example, someone who is otherwise a 50% partner can be allocated 90% of

⁷²I.R.C. § 731(a).

⁷³I.R.C. § 732(a)(1). However, that basis can never exceed the recipient partner's basis in his or her partnership interest. I.R.C. § 732(a)(2).

⁷⁴Section 707(a)(2)(B) was Congress's first pass at this area. It addresses the situation in which there is a direct or indirect transfer of money or property by a partner to a partnership and a related direct or indirect transfer of money or other property by the partnership to the partner. If the facts indicate that the transfers are in substance a sale or exchange, that is how they are treated (and not as a nontaxable contribution and distribution under sections 721 and 731). The Regulations provide a presumption that if the exchanges take place within two years of one another, there is a rebuttable presumption that they are related, subject to some exceptions. Reg. § 1.707-3(c)(1).

Section 704(c)(1)(B) of the Code provides that if a partner contributed property to a partnership and that property is distributed to another partner within seven years of the contribution, the contributing partner recognizes any gain or loss from the sale of the property. The gain or loss recognized is the amount that would have been recognized under section 704(c)(1)(A) if the property had been sold at its fair market value at the time of the distribution.

Section 737 of the Code provides that if a partner contributes appreciated property to a partnership, and other property is distributed to the contributing partner within seven years, the contributing partner recognizes gain to the extent of the lesser of the amount by which the fair market value of the distributed property exceeds the partner's basis in his or her partnership interest or the net precontribution gain. The net precontribution gain is defined as the gain that would have been recognized under section 704(c)(1)(B) if the contributed property had been distributed to another partner within seven years of the contribution.

Note that section 707(a)(2)(B) does not automatically apply, whereas sections 704(c)(1)(B) and 737 do. If it does apply, section 707(a)(2)(B) makes the transaction fully taxable. That is not necessarily the case with the other two code sections.

⁷⁵See *supra* text accompanying notes 38–40.

the depreciation deductions.⁷⁶ In an S corporation, all allocations of income, loss or deductions, must be based on the shareholders' stock holdings.⁷⁷ Under certain circumstances, an S corporation can effectively vary that allocation. It can pay a shareholder-employee a larger salary in a given year. A deserving shareholder-employee can be given an option to buy stock that can be exercised to increase corporate ownership, and thereby increase income and loss allocations.⁷⁸ While these substitute methods can be helpful, they are just that, substitute methods, and do not offer the flexibility of the special allocations rules available to the partnership form.

3. *Entity Debt*

Under section 752, an increase in a partner's share of partnership liabilities is treated as though the partner contributed money to the partnership to the extent of her share of partnership liabilities.⁷⁹ Like any other contribution, these amounts increase the partner's basis in her partnership interest.⁸⁰ It is difficult to overstate the value of being able to increase outside basis with partnership debt. A partner is allowed to deduct her share of partnership losses to the extent of that basis.⁸¹

In all but one of the circuits that have examined the issue, debt incurred by an S corporation does not increase the shareholders' stock bases, even if the shareholders' guarantee the debt and the creditors view the shareholders

⁷⁶In order for a special allocation to be allowed, under the safe harbor it must have "substantial economic effect." I.R.C. § 704(b). The substantial economic effect test has two parts, the "economic effect test" and the "substantiality test." Reg. § 1.704-1(b)(vii)(2).

In order for the economic effect test to be met, partners' capital accounts must be maintained in accordance with certain rules. The capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. Reg. § 1.704-1(b)(2)(iv)(b). The other requirements of the economic effect test are that a partner must be paid the balance of her capital account on liquidation of her interest, and if a partner has a deficit capital account, she must restore it on liquidation of that interest. Reg. § 1.704-1(b)(2)(ii). Under an alternative safe harbor, an allocation is allowed even if a partner does not have a deficit restoration obligation, provided, *inter alia*, the allocation does not cause or increase a deficit account balance. These are sometimes known as the qualified income offset or "QIO" rules. *See* Reg. § 1.704-1(b)(2)(ii)(d).

The substantiality test requires that the economic effect of an allocation of a partner be "real." For example, if a partner is allocated a loss, on a present value, after tax basis, his position must be diminished and that of the other partners must be enhanced. If this does not occur, the economic effect of the allocation is not substantial. Reg. § 1.704-1(b)(2)(iii).

⁷⁷I.R.C. § 1366(a).

⁷⁸This option should not violate the one-class-of-stock rule. Reg. § 1.1361-1(l)(4)(iii)(B)(2).

⁷⁹Similarly, a decrease in a partner's share of partnership liabilities is treated as a distribution of money. I.R.C. § 752(b).

⁸⁰I.R.C. § 705(a)(1).

⁸¹Subject to the loss limitation provisions of Code sections 465 and 469.

as the primary payors.⁸² A shareholder of an S corporation can only deduct losses to the extent of the basis in the stock plus the basis of any loans by the shareholder to the corporation.⁸³ A shareholder's inability to include an appropriate share of corporate debt in stock basis can thus be troublesome. To avoid the impact of this rule, a shareholder can borrow the funds directly and then loan or contribute the funds to the corporation, thereby receiving an increased stock or debt basis, against which losses can be deducted. Not all shareholders are well enough advised to know to borrow the funds directly. Further, when the debt is secured, loaning the funds via a shareholder is often awkward. Who would own the secured property, the corporation or the shareholder? If the corporation, why would the corporation provide security for a loan to a shareholder? Is the provision of security a distribution to the shareholder? If the shareholder owns the security, is it property the corporation needs? Would it have to be rented to the corporation? Is adequate liability insurance available to protect the corporation and the shareholder against mishaps while the corporation uses the property? What if an S corporation (especially one with numerous shareholders) wants to buy a property subject to debt? Is it practical to have the shareholders buy the property, contribute it to the corporation, but stay primarily liable on the debt? What if the debt secured by the property is nonrecourse and therefore it is not possible for the shareholders contributing the property to remain liable on the debt? Finally, lenders often prefer to have the primary obligor be the primary debtor. These types of considerations often mean that the parties cannot avoid a loan being made directly to the corporation.

⁸²Grojean v. Commissioner, 248 F.3d 572 (7th Cir. 2001); Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989). *Contra* Selfe v. United States, 778 F.2d 769 (11th Cir. 1985). The court in *Selfe* held that debt-equity principles developed under subchapter C of the Code could be used in determining whether a corporate debt guaranteed by a shareholder could be characterized as a capital contribution. The case involved somewhat unusual facts in that the loan was originally made to the taxpayer and then converted to corporate loans when the taxpayer incorporated her business. The Eleventh Circuit ruled against the taxpayer in *Sleiman v. Commissioner*, 187 F.3d 1352 (11th Cir. 1999), which involved more traditional facts (original loan to corporation, guaranteed by shareholders). The *Sleiman* court did not overrule *Selfe*, however, and indeed seem to confirm its holding.

For an example of how sloppy paperwork can be fatal see *Bolding v. Commissioner*, 70 T.C.M. (CCH) 110, 1995 T.C.M. (RIA) ¶ 95,326 (A shareholder obtained a line of credit from a bank. Funds were disbursed from the line of credit directly to the S corporation at the shareholder's direction. The Court held that the funds did not constitute a contribution to the equity of the corporation because, based on the taxpayer's testimony, the funds were included on the corporation's balance sheet as "Loans from Shareholders." The Tax Court, however, did not treat the funds as an indebtedness of the corporation to the shareholder either, because the court could not determine that the funds borrowed from the bank constituted part of the balance of the "Loans from Shareholders." The loans from the shareholder were not evidenced by promissory notes or clear book entries.).

⁸³I.R.C. § 1366(d).

4. Section 754 Election

Another substantial advantage of the partnership over the S corporation is the availability of the "section 754 election." Among the times a section 754 election can be useful is when a partnership interest is purchased or inherited. If an election is made, the "inside basis" of the purchasing or inheriting partner's share of partnership assets is increased or decreased to equal the outside basis of that partner's partnership interest.⁸⁴ If the inside basis of a partner's share of partnership assets is "stepped up" as a result of the election, when the relevant assets of the partnership are sold, the purchasing or inheriting partner does not recognize gain to the extent of pre-acquisition appreciation. The partner also is able to use the higher inside basis for computing depreciation and other relevant deductions.⁸⁵ What is good for the goose is good for the gander, and a section 754 election can result in a downward adjustment if, at the time the purchasing or inheriting partner acquires an interest, the assets of the partnership have a fair market value that is less than their bases.⁸⁶ If a partnership has partners regularly coming and going, section 754 elections can become a major accounting headache, though the computer age has reduced the pain.

Generally, a section 754 election is just that, an election. Logically, one would make the election if it means an upward adjustment and not make it if it means a downward adjustment. Life is sometimes that good, but often is not. Once an election is made, it cannot be undone without the consent of the Service.⁸⁷ If the partnership makes the election when a partnership interest is purchased when the good times are rolling, it is most likely stuck with it if a partnership interest is again purchased when the good times are no longer rolling. The Service will not permit an election to be revoked merely to avoid a downward adjustment.⁸⁸ Further, a downward adjustment is mandatory if, at the time of the transfer of the partnership interest, the partnership's adjusted basis in the partnership property exceeds by more than \$250,000 the fair market value of such property.⁸⁹

Comparable adjustments to inside partnership bases are also possible when a partner recognizes a gain or loss on a partnership distribution to him. Again, a downward adjustment can be required in some cases where a loss is recognized.⁹⁰

⁸⁴I am putting in very simple terms rules that are highly complex. See I.R.C. §§ 743, 754, 755; Reg. §§ 1.743-1(b)-(d), 1.755-1.

⁸⁵Reg. § 1.743-1(b)-(d), (j).

⁸⁶*See id.*

⁸⁷Reg. § 1.754-1(c).

⁸⁸Permission may be given if there has been a substantial change in the nature of the partnership's business, a substantial increase in the assets of the partnership, a change in the character of the partnership assets, or an increased frequency of retirements or shifts of partnership interests. See Reg. § 1.754-1(c).

⁸⁹I.R.C. § 743(d).

⁹⁰I.R.C. §§ 734(b), 754, 755; Reg. § 1.743(b), (c).

A section 754 election in many respects permits greater accuracy. When a taxpayer purchases an interest in an entity, he is ultimately looking at the value of the assets in that entity to determine what he should pay. Especially for a pass-through entity, being able to harmonize inside and outside basis ensures that the tax consequences of the investment mostly closely match the economics of the investment. For example, if the partner buys the partnership interest when a given partnership asset is worth \$100, and the partnership sells the asset for \$100, the partner has no economic gain or loss. Without a section 754 election, however, the partner may be allocated *tax* gain or loss if the partnership's basis in that asset is other than \$100. For this reason, among others, there have been suggestions that section 754 elections be made mandatory across the board.⁹¹ Mandatory elections have been resisted in part because of the greater complexity they add to the system, but may gain new momentum if Subchapter S is repealed, permitting greater attention to be focused on Subchapter K.

For all of its complexity, most tax advisors agree that the existence of the section 754 election is a good thing, at least for their clients. No analog to the section 754 election exists for an S corporation. Thus, upon buying or inheriting stock in an S corporation, the stockholder takes a basis in the stock equal to its fair market value as of the date of purchase or the decedent's date of death.⁹² He cannot adjust the inside basis of the S corporation's assets to equal the possibly higher outside basis of the corporate stock. Upon a sale of appreciated corporate assets, the shareholder is taxed on a proportionate share of the income, notwithstanding the fact that this income might increase the basis of his stock in excess of its fair market value. The shareholder might not be able to take advantage of the loss inherent in the stock until the stock is sold, which could be well into the future. Further, the shareholder's recognized loss on the stock normally is a capital loss whereas the gain on the sale of the relevant property may be ordinary income, resulting in a character distortion in addition to a timing distortion. Finally, if a shareholder dies before disposing of the stock, he takes his losses with him. The loss disappears because his heirs take a fair market value basis in the stock under section 1014.

5. *Compensation for Services*

Often some owners contribute the capital necessary to start the business, while others perform the services that will hopefully make the business successful. How should the service owners be compensated? Partners can hold two different types of partnership interests: A capital interest, entitling the recipient to an interest in the underlying capital of the partnership, or a profits interest,

⁹¹ See GEORGE K. YIN & DAVID J. SHAKOW, *TAXATION OF PRIVATE BUSINESS ENTERPRISES* 371–77 (1999) [hereinafter ALI Report]; Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2003, S. 1072, 108th Cong. § 5683 (2003); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 469 (2004).

⁹² I.R.C. §§ 1012, 1014(a). In the case of inherited stock, the valuation date can sometimes be later than the date of death. See I.R.C. § 1014(a).

entitling the recipient to share only in future profits of the partnership. The two types of interest are typically taxed differently. The fair market value of a capital interest given in exchange for services is taxable to the recipient.⁹³ Rarely, however, is a capital interest exchanged for services, because, in effect, the “money partners” would be giving a share of their contributions to the service partner. It is more common for a service provider to receive a profits interest. Currently, in most circumstances, a profits interest is not taxable on receipt.⁹⁴ I say currently, because the Service has proposed, and may soon finalize, regulations that at least technically will change this result.⁹⁵ These Proposed Regulations provide that any partnership interest, profits or capital, is property.⁹⁶ Outside the partnership context, it is long established law that the fair market value of property received in exchange for services is ordinary income, and the Proposed Regulations seek to implement this rule fully in the partnership context.⁹⁷ Under most circumstances, however, the Proposed Regulations allow a partnership interest to be valued at its liquidation value.⁹⁸ If a true future profits interest is involved, its liquidation value is commonly zero as the future profits have not yet been earned and cannot reliably be predicted. Thus, while there is a lot of smoke, there is often not going to be much fire. A service partner usually incurs no income on receipt of a profits interest now, and will also usually incur no income if the Proposed Regulations are finalized. Of course, when the partnership earns profits, the partner holding a profits interest includes his distributive share of those partnership profits in

⁹³I.R.C. § 83(a); Reg. § 1.721-1(b)(1). Under section 83(a), the incidence of income is deferred if the partnership interest is subject to a substantial risk of forfeiture.

⁹⁴Rev. Proc. 1993-27, 1993-2 C.B. 343. If a person, acting as a partner or in anticipation of becoming a partner, provides services to or for the benefit of the partnership and receives a profit interest in return, the Service will not treat this transaction as taxable provided:

1. the interest does not relate to a predictable stream of income;
2. the partner does not dispose of the interest within two years; or
3. the interest is not of a “publicly traded” limited partnership.

⁹⁵See Prop. Reg. § 1.83-3(l), 70 Fed. Reg. 29,675 (2005).

⁹⁶See *id.*

⁹⁷See I.R.C. § 83(a); Prop. Reg. § 1.83-3(e), 70 Fed. Reg. 29,675 (2005) (explicitly providing that “property” includes a partnership interest); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Int’l Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943); see also New York State Bar Association Tax Section, *Proposed Regs and Rev. Proc. on Partnership Equity Transferred in Connection with the Performance of Services*, 109 TAX NOTES (TA) 1311 (2005); Marty McMahon, *Recognition of Gain by a Partnership Issuing an Equity Interest for Services: The Proposed Regulations Get it Wrong*, 109 TAX NOTES (TA) 1161 (2005).

⁹⁸See Proposed Regulation section 1.83-3(l), 70 Fed. Reg. 29,675 (2005), which provides for a safe harbor for when liquidation value may be used, and the related Proposed Revenue Procedure in Notice 2005-43, 2005-24 I.R.B. 1221. The Proposed Revenue Procedure provides that the safe harbor may be used when the partnership interest (including a profits interest) received is *not* (1) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (2) transferred in anticipation of a subsequent disposition, or (3) an interest in a publicly traded partnership within the meaning of section 7704(b). See Notice 2005-43, 2005-24 I.R.B. 1221. These are very similar to the rules of Revenue Procedure 1993-27, 1993-24 I.R.B. 63.

income under section 702.

While this Article is not the place to engage fully the “carried interest debate,” it should be noted that this advantage of partnerships has at times engendered controversy. The service provider usually has the same ordinary income tax consequence in the partnership context that she has outside the partnership context.⁹⁹ The service provider receiving nonpartnership property for services has ordinary income equal to the fair market value of the property received. The profits earned and allocated to the service provider-partner are also ordinary income—well there is the rub; that is usually the case, but not always. If the service provider is running a private equity fund, and the profits generated by the fund are from the sale of, say, capital assets held for over one year, the fund’s profits consist of long term capital gains taxed at a 15% rate rather than ordinary income taxed at (maximally) a 35% rate.¹⁰⁰ The fact that fund managers may be compensated for their services with 15% rather than 35% dollars has caused more than a little consternation in Congress, and the House passed a bill that would have changed this outcome, though it was never ultimately enacted.¹⁰¹ Whatever the result of the carried interest debate, the underlying rule for profits interest is unlikely to be changed dramatically outside the private equity fund arena, and indeed it is not readily changeable. The uncertainty of future profits usually means a future profits interest is valued at zero.¹⁰² Thus, overall, this advantage for partnerships likely has a bright future.

In the S corporation universe, on the other hand, there is only one type of ownership interest that can be given a service provider: stock.¹⁰³ The fair market value of an unrestricted stock interest is income to the recipient, no

⁹⁹The timing of when the ordinary income is recognized can, however, be very different.

¹⁰⁰See I.R.C. § 1.

¹⁰¹To Amend the Internal Revenue Code of 1986 to Extend Certain Expiring Provisions, and for other Purposes, H.R. 3996, 110th Cong. (2007); see Chris Sanchirico, *Taxing Carry: The Problematic Analogy to “Sweat Equity,”* 117 TAX NOTES (TA) 239 (2007); Michael L. Schler, *Taxing Partnership Profits Interests as Compensation Income*, 119 TAX NOTES (TA) 829 (2008); Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 117–18 (2008); Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323 (2007); David A. Weisbach, *Professor Says Carried Interest Legislation Is Misguided*, 2007 TAX NOTES TODAY 505 (2007).

For earlier but still relevant articles see Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) (in which Professor Gergen recommends treating the compensatory allocations to a partner as ordinary salary income). For a trio of related articles discussing this issue (the latter two commenting on the first and adding their perspective) see Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247 (1992); W. Lesse Castleberry, *Commentary: Campbell—A Simpler Solution*, 47 TAX L. REV. 277 (1992); and Leo L. Schmolka, *Commentary Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1992).

¹⁰²See *St. John v. United States*, 84-1 U.S.T.C. ¶ 9158, 53 A.F.T.R.2d 84-718, 84-721 (C.D. Ill. 1983).

¹⁰³See I.R.C. § 1361(b)(1); see also Reg. § 1361-1.

ifs, ands, or buts about it.¹⁰⁴ Note that the S corporation service provider is given the equivalent of a partnership capital interest. If the S corporation is liquidated the day after the service provider is given an unrestricted stock interest, she receives a share of the S corporation's assets, even if they were contributed by others. Thus, the unrestricted stock received always has current value, something that is not necessarily the case for a partnership profits interest.

B. *Advantages of S Corporations over Partnerships*

1. *Background*

Before beginning this discussion, I should mention an advantage that S corporations once had, but no longer do. Indeed, this advantage was so significant, it might have alone justified keeping Subchapter S alive. Before the advent of LLCs, S corporations were a good solution for the "Mom and Pop" business. Pre-LLCs, the only way to give the business a liability shield and the benefits of partnership taxation was to form a limited partnership with a corporate general partner. Mom and Pop could have been the limited partners as well as the officers and directors of the corporate general partners. But, this meant that Mom and Pop had to manage two entities, and be careful not to engage in management activities when they had their limited partner hat on; doing otherwise could lead to personal liability.¹⁰⁵ Mom and Pop usually could not be trusted to keep things straight so many advisors put them in an S corporation. It was a second best, but safer choice.¹⁰⁶ But now Mom and Pop can use an LLC and have the benefits of partnership taxation, while operating out of a single entity that in most states is less burdensome to keep straight than a corporation.¹⁰⁷ Further, in these closely held entities, the complexities of Subchapter K are mostly held in abeyance, so that the LLC also is a fairly simple entity for tax purposes.¹⁰⁸

Numerous changes have been made to Subchapter S to make it more appealing. As I noted above, it may now have up to 100 shareholders. Section 501(c)(3) organizations, pension plans, and family trusts may now be shareholders. An S corporation can own a QSSS and own stock in C corporations.¹⁰⁹ But few are benefitted by these changes. Over 88% of S corporations

¹⁰⁴I.R.C. § 83(a) (stating that the incidence of income is deferred in the stock interest subject to a substantial risk of forfeiture).

¹⁰⁵In the interim, the rules for limited partner participation have been liberalized in many states. See Unif. Ltd. P'ship Act § 303 (2001).

¹⁰⁶See BISHOP & KLEINBERGER, *supra* note 17, ¶ 1.01.

¹⁰⁷See BISHOP & KLEINBERGER, *supra* note 17, ¶ 3.08.

¹⁰⁸For example, special allocations may not be needed and section 754 elections are likely rare. See *supra* text accompanying notes 73–78, 84–92.

¹⁰⁹See *supra* text accompanying notes 56–61.

have two or fewer shareholders, almost always individuals.¹¹⁰ These changes thus benefit a small number of S corporations. The 100 shareholder rule is primarily valuable in S corporations where trusts own stock and an extended family is the beneficiary of the trusts.¹¹¹

The advantages of partnerships, in contrast, benefit the “everyday” LLC as well as the sophisticated model. Members of everyday LLCs make contributions of property to the LLC and receive distributions from it. These transactions are normally tax free under sections 721 and 731. While perhaps not a majority, a large number of LLCs make special allocations of income and loss to its members. Most entities, including everyday LLCs, have debt. Only in a partnership-type vehicle, such as an LLC, is section 752(a) available to permit owner-level bases to be increased by entity-level debt. Sales of ownership interests are common for all types of businesses, and owners of even the smallest business cannot avoid the grim reaper. Yet only a person buying or inheriting a partnership interest can receive an inside basis adjustment if an election under section 754 is in effect. Further, these considerations tend to drive the choice of entity decision.

But all that said there are a few circumstances when S corporations have the upper hand, though of relatively less importance and relatively few in number. As I discuss in detail below, these advantages do not provide adequate justification for the entire S corporation edifice. Those advantages that are legitimate should be incorporated into Subchapter K, those that are not should be abandoned.

2. Corporate Pathways

Some of the advantages that an S corporation has over a partnership have to do not with the S corporation taxation regime as such, but with the fact that an S corporation is just that, a corporation. Sometimes it is good to be a corporation. Some examples follow.

a. *Going Public.* While publicly traded partnerships and even publicly traded LLCs exist, the overwhelming majority of publicly traded entities are C corporations.¹¹² Thus, a business that wants to make a public offering usually needs to find its way into a C corporation. This process is quite a straightforward matter for an S corporation. An S corporation may terminate its S election with a majority vote of its shareholders.¹¹³ Thereafter, it is a C

¹¹⁰As of 2004. See INTERNAL REVENUE SERVICE, SOI TAX STATS – S CORPORATIONS, at tbl. 6 (2004) [hereinafter SOI TAX STATS], available at <http://www.irs.gov/pub/irs-soi/04co1120s06.xls> (last visited Apr. 2, 2009).

¹¹¹I.R.C. § 1361(c)(2)(B)(iii), (iv) (stating that family members can be treated as one shareholder, making the effective number of permitted shareholders theoretically vast); see I.R.C. § 1361(c)(1)(A), (B); see also EUSTICE & KUNTZ, *supra* note 59, § 3.04; Schiff Harden, LLP, TAX UPDATE (Oct. 22, 2004), http://www.schiffhardin.com/binary/tax_102204.pdf.

¹¹²BISHOP & KLEINBERGER, *supra* note 17, § 16.01.

¹¹³I.R.C. § 1362(d)(1)(b) (stating that a final S corporation return must be filed).

corporation and the public offering of the stock can proceed.¹¹⁴

For a partnership, matters are more complex. There are two main options.¹¹⁵ In "Option One," the partnership contributes its assets to the corporation in exchange for stock. The partnership then liquidates and distributes the stock to its partners. In "Option Two," the partners contribute their partnership interests to the corporation in exchange for stock, liquidating the partnership as a matter of law, because a single owner—to wit, the corporation—remains.¹¹⁶

The potential problem lies not with the liquidation of the partnership, but with the incorporation. The liquidation of the partnership is typically, and usually straight forwardly, tax free under sections 731. The incorporation will be tax free to the corporation under section 1032, but for it to be tax free to the contributing shareholders, it must fall within section 351(a). As I discussed above, section 351(a) provides that a contribution of property to a corporation is tax free if the contributing parties receive only stock in the exchange and are in 80% control of the corporation "immediately after the transfer."¹¹⁷

Does section 351(a) apply to Options One and Two? The critical issue is whether the contributing shareholders have 80% control "immediately after" the property is contributed in exchange for stock. In Option Two, the answer is clearly yes as the stock goes directly to the partners. In Option One, where the stock first goes to the partnership and then to the partners, the concern is whether the partnership's ownership of the stock is so transitory that it prevents the section 351(a) requirements from being met. In Revenue Ruling

¹¹⁴Corporations do not recognize gain or loss on the receipt of property in exchange for stock. I.R.C. § 1032. If the purchasers buying the stock pay with cash, as is typical, there is no gain or loss to them either. Thus, section 351 is not needed. See Benjamin G. Wells, *Planning for the Special Tax Problems That Arise in Taking an S Corporation Public*, 80 J. TAX'N 164 (1994); see also Victor Fleischer, *Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137 (2003); Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-Up: The Myth of Incorporation*, 55 TAX LAW. 923 (2002); Joseph Bankman, *Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1994).

¹¹⁵A third approach is for the partnership to liquidate and distribute its assets to the partners, who could then contribute them to the corporation. The mechanics of this approach are more problematic. Two sets of state transfer taxes could apply, for example, one on the partnership's distribution to the shareholders and another on the partners' contribution to the corporation. Further, if there is an actual or deemed distribution of money to a partner in excess of his basis in his partnership interest, he would have to recognize gain under section 731(a)(1) to the extent of the excess. In addition, if the transfers to the corporation were not done contemporaneously with the liquidation of the partnership (admittedly quite unlikely), there would be the risk that a given partner might not be willing to contribute a particular property, or might have sold it, etc. Even if these problems did not exist, it is hard to see why one would not prefer Options One or Two.

¹¹⁶Unif. P'Ship Act § 101(6) (1997) (defining a partnership as an association of two or more persons).

¹¹⁷Section 368(c) defines control to mean ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

1984-111, however, the Service ruled that where, as in Option One, there is a contribution of property by the partnership to the corporation followed by a liquidation of the partnership, the requirements of section 351(a) are met.¹¹⁸ In effect, the Ruling ignores the fact that the partnership's ownership of the stock is brief.

Does the answer change if a public offering follows the incorporation? Revenue Ruling 1984-111 does not address this question. The issue is whether the shareholders obtaining stock from the public offering have to be counted for purposes of the 80% control test, and if so, when they are counted. If the contribution to the corporation by the partners or the partnership is treated as fully separate from the public offering, there is no problem because there is 100% control immediately after the original formation of the corporation. If the contributions to the corporation by the partners or the partnership and the contributions by the participants in the public offering are treated as a single transaction, there is still no problem because the contributors also have 100% control immediately after the contribution. However, if section 351 defines the control group as *both* the partners or the partnership *and* the public purchasers, and if the partners or partnership are considered to make their contributions at different times, section 351 does not apply to *any* contributor.¹¹⁹

To complicate this complex situation further, there are two possible scenarios. One is where, prior to incorporation, the partners and the partnership have no agreement with an underwriter to make a public offering of the stock. The other scenario is just the opposite, where the partners do have that agreement. Typically, the partners will prefer the latter scenario. Once incorporated as a C corporation, the corporation and the owners may have to incur two levels of taxation to get back to a partnership.¹²⁰ Thus, if the primary reason for incorporating is to go public, the partners want to be sure the public offering is going to happen before tripping the incorporation domino.

¹¹⁸ See Rev. Rul. 1984-111, 1984-2 C.B. 88 (revoking Rev. Rul. 1970-239, 1970 C.B. 74, which came to the same conclusion with regard to the section 351(a) issue). Revenue Ruling 1970-239 held that the tax consequences of all three scenarios were the same. Revenue Ruling 1984-111 revokes that holding, concluding that the tax consequences of the different options can vary. Assuming § 351(a) applies, then in the case of Option One, the partnership takes the same basis in the stock that it had in the contributed property under § 358(a). Then the partnership liquidation rules kick in. Generally, the distributee partners will allocate their bases in the partnership interest to the stock. See I.R.C. § 732. In the case of Option Two, under § 358(a), the erstwhile partners take as their bases in the stock, the bases they had in the contributed partnership interests. I should perhaps note that there is no question here that the parties are contributing "property" to the corporation, one of the requirements of § 351(a). Contributions of services will not generally count. See BITTKER & EUSTICE, *supra* note 10, § 3.02[2].

¹¹⁹ It would be highly unusual for less than 20% of the stock to be sold in a public offering. Normally, participants in a public offering are contributing cash to the corporation, so for them no gain recognition exists. Under section 1032, there is also no income to the corporation.

¹²⁰ See *supra* text accompanying notes 25-26.

If the agreement is reached with the underwriter after incorporation, the control test of section 351(a) is most likely met. The contribution by the partners or partnership is most likely seen as wholly separate from the public offering. Current case law generally looks to whether there is a binding obligation made *before* incorporation by the shareholders to dispose of the stock.¹²¹ If so, the stock that is the subject of that agreement cannot be counted toward the 80% control test. If there is no such agreement, all of the stock that is received can be counted toward the 80% test. The Tax Court summarizes the law as follows:

A determination of "ownership," as that term is used in section 368(c) and for purposes of control under section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, *it is immaterial* how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation.¹²²

¹²¹ See, e.g., *Intermountain Lumber v. Commissioner*, 65 T.C. 1025, 1031-32 (1976).

¹²² *Id.* at 1031-32 (emphasis supplied); see BITTKER & EUSTICE, *supra* note 10, § 3.09[2] (also containing this quote). It is sometimes also said that even without a binding obligation, the taxpayer fails to comply with section 351 if the loss of control is both part of a preconceived plan and a sine qua non thereof. BITTKER & EUSTICE, *supra* note 10, § 3.09[2]. The anti-taxpayer authority for this, however, is rather thin. There is one case, *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966), in which an exchange of the shares received in the incorporation in a purported B reorganization was imminent, but no binding agreement to make the exchange was in effect. The Tax Court held that section 351(a) did not apply to the incorporation, notwithstanding the lack of a binding agreement to exchange the shares, in part because the incorporation lacked a business purpose. *Id.* at 40. *West Coast* is inconsistent with the Tax Court's later holding in *Intermountain*. As both are Tax Court cases, the later holding of *Intermountain* should be controlling. The other contrary authority is the hoary Revenue Ruling 1954-96, 1954-1 C.B. 111, which, of course, is not binding on the judiciary. Further, the trend of the Service's rulings is pro-taxpayer. Recently, the Service ruled that the section 351(a) requirements were met even where there was a binding obligation to transfer the stock received in the section 351 transaction, where there was an alternative tax free, section 351(a) way of structuring the transaction. See Rev. Rul. 2003-51, 2003-21 I.R.B. 938. Finally, there is some support in the Regulations for the Tax Court's holding in *Intermountain*. Reg. § 1.351-1(a)(1) ("[I]mmediately after the exchange does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.") (emphasis supplied). The language about the rights of the parties having been "previously defined" is consistent with the binding agreement approach. I found no circuit court decisions inconsistent with the binding agreement test in the section 351 context. Indeed, the Tax Court cites a number of circuit courts in support of its decision in *Intermountain*. See *Intermountain Lumber*, 65 T.C. at 1032. That said, a given appellate court

An obligation to dispose of stock could be interpreted to include new stock to be issued by the corporation. But there is no such binding obligation to issue additional stock if the agreement with the underwriter is made *after* incorporation. Thus on incorporation of the partnership the requirements of section 351(a) should be met. It is conceivable a court could disagree with the Tax Court's analysis, but that has not happened since the case came out in 1976, over 30 years ago.

And if there is such a binding obligation with the underwriter before incorporation? The Service historically has taken a pro-taxpayer approach.¹²³ The Treasury and the Service solidified their views (if perhaps not the clarity with which they were expressed) in Treasury Regulation section 1.351-1(a)(3) in 1996. It provides that if a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, that person is treated as transferring the cash directly to the corporation in exchange for stock.¹²⁴ Further, the Regulations also provide that in determining whether the 80% test is met, simultaneity is not required, "but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."¹²⁵ Finally, the preamble to Treasury Regulation section 1.351-1(a)(3) provides:

[A]lthough the regulations specifically concern underwriting, it is intended that its principles could apply equally in *factually analogous situations*. For example, if the ownership by other intermediaries in the distribution of stock . . . , such as broker-dealers, is transitory, that ownership should also be disregarded.¹²⁶

Reading these provisions together along with Revenue Ruling 1984-111, it seems clear that the incorporation of the partnership under either Option One or Two, coupled with a public offering of the underlying stock, falls within section 351(a), even if there is a binding obligation to make the public offering prior to incorporation. To summarize: (1) the transfers by the partners or the partnership to the corporation and the transfers of the moneys to the corporation from the public offering do not need to be simultaneous, (2) in Option One, the transience of the partnership's ownership is effectively ignored, and (3) the transfers from the public offering are deemed to go directly to the corporation, even if the underwriter is a way station. Thus,

could apply the step transaction doctrine in a way that prevents section 351(a) from applying if there was a preconceived plan as suggested in BITTKER & EUSTICE, *supra* note 10, even if there was no binding agreement. See also Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349 (1991).

¹²³ See Rev. Rul. 1978-294, 1978-2 C.B. 141, *superseded by* Reg. § 1.351-1(a)(3).

¹²⁴ Reg. § 1.351-1(a)(3). A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

¹²⁵ Reg. § 1.351-1(a)(1).

¹²⁶ T.D. 8665, 1996-1 C.B. 35 (emphasis supplied).

assuming the public offering occurs promptly after incorporation, both the partner contributors and the public offering contributors should be seen as part of one group, and, of course, that group has control of the corporation once the smoke clears.¹²⁷ Thus, the taxpayers will not be denied the benefits of section 351(a).¹²⁸

While there are few federal income tax hurdles to a partnership incorporating and making a public offering of the stock, there may be state law hurdles. State and local transfer taxes as well as transfer consents from mortgagors, landlords, etc. could be issues for an incorporating partnership.¹²⁹ Typically, they are not issues on the conversion of an S corporation into a C corporation, because from a nontax perspective there has been no change. The same state law entity, to wit, the corporation, exists both before and after its conversion, subject to a different type of federal income tax treatment.

The public offering arena is one in which the S corporation has some advantages, though if there are few or no state law hurdles, the disadvantages of the partnership form are likely not substantial. Getting to the public offering from a partnership form may involve more hassle than getting to it from an S corporation form, but often the hassle is worth it. Much may depend on how soon the public offering is planned (recalling that more businesses plan to go public than actually go public). If many years may go by between the

¹²⁷ If there is a dramatic delay in the public offering, and there was a pre-incorporation binding obligation to do the public offering, it could prove awkward. On the one hand, the binding agreement makes it hard to ignore the public shareholders, on the other hand, a long delay makes it harder to say there was control by the public and nonpublic shareholders "immediately after" the exchange. I did not come across a case on point, but the Regulations suggest the Service would take a liberal approach. See Reg. § 1.351-1(a)(1), (3).

¹²⁸ See Goldberg, *supra* note 114, at 927-929. Those joys will be tempered, however, if the liabilities of the partnership are greater than the partnership's bases in its contributed assets (Option One), or if the liabilities allocated to partners are greater than the partners' bases in their contributed partnership interests (Option Two). In that event, and to that extent, gain will be recognized under section 357(c). Note that gain on incorporation will generally be a consequence of prior deductions which reduced the bases of the assets and partnership interests. Given the time value of money, the deductions will generally be more pleasurable than the gains are painful. Section 357(c) trumps section 351(a), providing an exception to the general rule of nonrecognition. I.R.C. § 357(c). Gain must be recognized to the extent the liabilities of a transferor exceed the transferor's basis in the contributed assets. I.R.C. § 375(c). Operating in parallel, section 752(b) would effectively allocate the gain among the partners. I.R.C. § 752(b). Section 752(b) provides that if a partner is relieved of liabilities, that is treated as a distribution of money to the partner. I.R.C. § 752(b). Section 731(a)(1) in turn provides that if a distribution of money exceeds a partner's basis in her partnership interest, gain is recognized. I.R.C. § 731(a)(1). The gains may be ordinary or capital gains. The gain is generally allocated among the assets based on their relative fair market values, and the character of the gain is generally a function of the type of appreciated assets contributed. See Rev. Rul. 1968-55, 1968-1 C.B. 140. Some tax arbitrage is possible here. Depreciation on real estate reduces ordinary income, whereas the gain, if the property is held over one year, is long-term capital gain taxed, generally, at a 25% rate up to the depreciation taken, and 15% thereafter. See I.R.C. § 1(h)(C), (D).

¹²⁹ See, e.g., MD. CODE ANN., TAX-PROP. § 13-201 et seq. (LexisNexis 2007).

original formation and the public offering, the tax advantages of a partnership in the interim often outweigh the cumbersomeness of going public. On the other hand, if a public offering is expected to occur in the near term, a partnership may not be worth the bother. An S corporation may make more sense. It still permits the flow through of losses to the stockholders, provided the stockholders have sufficient stock bases to allow for the deduction of the losses.¹³⁰ Note that such “start-ups,” particularly in the nanotech, biotech, and information technology arenas, commonly operate at a loss for a number of years.

Venture capitalist funds commonly have a generic preference for the corporate form. While the use of an S corporation would permit a venture capital fund to participate in losses, unlike the individual investor, its interest in tax losses is often limited. When the venture capitalist fund invests in a company, its principal concern is the exit strategy. Usually this is a public offering, though, as I discuss below, it can also include an effort to position the company for a takeover. If the venture capital fund holds common stock, it will want to be able to force the corporation to register the shares at the time of the “initial public offering” or “IPO.”

Often, however, the venture capital fund does not want common stock at the time of investment (pre-IPO), but preferred stock that has preferential liquidation and redemption rights, and possibly preferential dividends. If the venture capital fund needs to receive preferred stock, the S corporation form is unavailable because S corporations are only permitted to have one class of stock.¹³¹ The venture capital fund usually also wants an ironclad right to convert this preferred stock into common, and have the right at the time of the public offering to have that common stock registered.

If an LLC or other tax partnership is used instead of a corporation, the documents are much more challenging to draft as the parties have to find a way to obligate a yet-to-be-formed corporation to issue common stock, and register that common stock for public trading, on some sort of fixed conversion basis with the membership units of the existing LLC. Further complicating matters is the fact that in many cases there is not simply one venture capital financing round, but many. It is much easier to create a new series of preferred stock for each financing round than create legally reliable series of special membership interests in LLCs. All this can make LLCs not worth the trouble, particularly when the venture capital funds are far more interested in obtaining a big pay day at the end of the road rather than near-term tax benefits. If the venture is unsuccessful, venture capital funds can still receive a section 165 loss deduction on their investment. Indeed, some venture capital funds, when they find a company that they really like that is currently an LLC, require that it be

¹³⁰I.R.C. § 1366(d) (S corporation shareholders are also allowed to deduct losses to the extent of any debt owed them by the corporation).

¹³¹I.R.C. § 1361(b)(1)(D). Differences in voting rights are permitted. I.R.C. § 1361(C) (4).

converted over to a C corporation before they invest.¹³²

While I discuss ways below to smooth the conversion of LLCs and other tax partnerships into corporations, there are limits. LLCs and tax partnerships do not fit every business model. Sometimes only a corporation will do. While the world can live without S corporations, it cannot live without the corporate form altogether.

b. *ESOPs*. Qualified pension trusts and section 501(c)(3) charitable organizations are permissible S corporation shareholders.¹³³ Qualified pension trusts and section 501(c)(3) organizations are generally tax exempt.¹³⁴ I will therefore call them tax-exempt organizations, though this descriptor is not fully apt, as I will discuss below. An employee stock option plan (ESOP), a type of pension trust, provides a good example of the benefit of the corporate form to this class of shareholders, and I will focus on ESOPs in this discussion.¹³⁵

To abbreviate in the extreme, an ESOP is a qualified pension plan that a corporation adopts.¹³⁶ Among an ESOP's purposes is to give the corporation's employees an equity interest in the corporation. The funds contributed to the ESOP by the corporation are generally tax deductible.¹³⁷ The stock in the corporation purchased by the ESOP is held in trust, and the corporation's employees are beneficiaries of the trust.¹³⁸

ESOPs are often designed to be cooperative purchasers of the stock of owners of closely held corporations.¹³⁹ Assume a corporation has a single shareholder who is also the CEO. The CEO is ready to sell her interest, but cannot obtain an offer for the stock she feels will pay her full value. Instead, she has the corporation form an ESOP. She sells her stock at full value to the ESOP. Commonly, the ESOP borrows the money for the purchase from a bank.¹⁴⁰ The corporation makes periodic, tax deductible contributions to the ESOP so

¹³²The reader will note the complete absence of footnotes for the above discussion. There apparently is little citable authority in this area. I owe my own understanding of this area to conversations with Professor Sean M. O'Connor of the University of Washington School of Law, an expert in the venture capital arena.

¹³³I.R.C. § 1361(b)(1)(B), (c)(6); *see also* I.R.C. § 401(a).

¹³⁴I.R.C. § 501(a).

¹³⁵Another reason for the coverage: I have been told informally, that in Congressional circles, some are defending S corporations due to their value to ESOPs.

¹³⁶A "qualified" plan is one to which contributions within certain limits are generally deductible and the income of which is generally tax exempt. These are subject to rules that limit discrimination in favor of highly compensated employees. *See* I.R.C. §§ 401(a), 404, 501(a).

¹³⁷*See* I.R.C. § 404(a)(3), (a)(9)(A).

¹³⁸*See* I.R.C. §§ 401, 4975(e)(7); *see also* *Uses of ESOPs*, 354 TAX MNGT. PORT. (BNA) A-1, -2 (2005) [hereinafter BNA]. In the words of Senator Long: ESOPs will "ensure that tomorrow's free enterprise system is financed so as to be more broadly owned." 129 Cong. Rec. S33,822 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

¹³⁹The following is based on a conversation I had with Henry Smith, a pension plan expert. *See also* BNA, *supra* note 138, at A-1.

¹⁴⁰*See* I.R.C. § 4975(d)(3).

that the ESOP can make payments on its indebtedness with the bank.¹⁴¹ As these contributions are made, the corporation's employees are given equitable interests in the stock held by the ESOP.¹⁴² If an employee retires, the ESOP is obligated to buy back his interest in the stock for fair market value unless it is traded on an established exchange, though the employee can demand to be given the stock.¹⁴³ If it works, ESOPs can be a win-win-win situation. The business owner receives full value for her business. As the contributions to the ESOP are tax deductible, the debt payments can be made, in effect, with pretax dollars. And the employees are provided with pension benefits and a participation in the business.¹⁴⁴

ESOPs are not all that common for two reasons. First, it can be difficult to find a bank that will make the loan. Second, the funds for the ESOP's purchase of the stock ultimately have to come from the corporation, and often it does not want to take on this financial burden.¹⁴⁵

To prevent tax-exempt organizations from destroying the tax base, Congress provides that "unrelated business taxable income" (UBTI) is taxed to them currently.¹⁴⁶ UBTI is income from a trade or business that is regularly carried on and is substantially unrelated to the tax-exempt organization's exempt functions.¹⁴⁷ Passive income, including dividends and gains on the sale of stock, is generally not UBTI.¹⁴⁸ It is thus normally safe for a tax-exempt organization to own stock in a C corporation, since the tax-exempt earnings will come in the form of dividends and stock gains.¹⁴⁹ A tax-exempt organization's share of the income of an S corporation, on the other hand, is UBTI.¹⁵⁰ (The same is true for its share of income of a partnership.¹⁵¹) But, the Code would

¹⁴¹ See I.R.C. § 404(a)(3), (a)(9)(A).

¹⁴² See I.R.C. § 4975(e)(7).

¹⁴³ I.R.C. § 409(h), (o).

¹⁴⁴ Of course, in the case of Enron, it was lose-lose-lose. See Martin A. Sullivan, *The Flawed Economics of ESOPs and Employee Stock Options*, 95 TAX NOTES (TA) 149 (2002); see also I.R.C. § 401(a)(28), (a)(35) (diversification rules).

¹⁴⁵ While ESOPs are permissible S corporation shareholders, it may make more sense to convert the S corporation to a C corporation before the stock sale to the ESOP is consummated. If the owner sells C corporation stock to the ESOP, she recognizes no gain to the extent she invests the proceeds in other qualifying C corporation stock (typically publicly traded securities). See I.R.C. § 1042.

¹⁴⁶ I.R.C. §§ 511, 512. "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of . . . organizations enable them to use their profit tax free to expand operations, while their competitors can expand only with profits remaining after taxes." Rep. No. 2375, 81st Cong., 2d Sess. 28, 1950-2 C.B. 483, 504.

¹⁴⁷ I.R.C. § 513; see *St. Luke's Hos. of Kan. City v. United States*, 494 F. Supp. 85 (1980); Rev. Rul. 1985-109, 1985-2 C.B. 165.

¹⁴⁸ I.R.C. § 512(b)(1), (b)(5). Note that the business income ultimately responsible for the dividends and stock gains is generally fully taxable.

¹⁴⁹ To avoid UBTI, the organization cannot control the corporation. I.R.C. § 512(b)(13).

¹⁵⁰ I.R.C. § 512(e)(1).

¹⁵¹ I.R.C. § 512(c).

not be the Code if the exception did not itself have an exception. And that is the case here. If an ESOP is the shareholder of an S corporation, its share of the income of an S corporation is not UBTI.¹⁵² There is no tax at any level on an S corporation owned entirely by an ESOP, making ESOPs an interesting option for S corporations.

Can an ESOP system be created for partnerships? While theoretically possible, it would be very difficult and highly complex to achieve in practice. Unlike corporations, partners generally must keep capital accounts. Capital accounts can be thought of as a measure of the economic value of a partnership interest, though at times they can be a highly imprecise measure.¹⁵³ Keeping capital accounts in proper form for ESOPs or their beneficiaries, with the stock holdings changing and beneficiaries coming and going, would be very challenging. The Service has issued proposed regulations on "regular" options to buy partnership interests.¹⁵⁴ The American Bar Association Tax Section made suggestions both before and after the Proposed Regulations were issued.¹⁵⁵ While the reader will be happy to hear that detailing these efforts is beyond the scope of this article, I will note that I participated in the ABA's part of the process and watched a lot of very smart people destroy a lot of brain cells trying to get to the right answer. Adapting ESOPs to partnerships is not necessary. The solution is straight-forward. Once the ESOP becomes appropriate, the partnership can incorporate. There should be no binding agreement in effect to create the ESOP before incorporation, less the stock being sold to the ESOP not be counted for purposes of the 80% control test.¹⁵⁶ Such a binding agreement is typically not needed. A small number of shareholders are usually in control and thus need not doubt that the corporation, once formed, will adopt the ESOP, which can then buy the stock.

c. *Takeovers.* S corporations, and C corporations for that matter, can be popular if the business's owners want ultimately to be the target of a takeover by a publicly held corporation. As noted above, venture capital funds often

¹⁵²I.R.C. § 512(e)(3).

¹⁵³A partner's capital account is increased by the money and fair market value of property contributed by that partner as well as income and gain allocated to the partner. A partner's capital account is decreased by the money and fair market value of property distributed to the partner, allocations to the partner that are not deductible and not capitalized, and allocations to the partner of loss and deduction. See Reg. § 1.704-1(b)(2)(iv)(b). Capital accounts play a vital role in the economic effect test of Regulation § 1.704-1(b)(2)(ii). See ARTHUR B. WILLIS, JOHN S. PENNELL, & PHILIP F. POSTLEWAITE, *PARTNERSHIP TAXATION* ¶ 10.03 (6th ed. 1997) [hereinafter WILLIS].

¹⁵⁴See Prop. Reg. § 1.704-1, 68 Fed. Reg. 2930 (2003); Prop. Reg. § 1.83-3, 70 Fed. Reg. 29,675 (2005).

¹⁵⁵See ABA Comments in Response to Notice 2000-29, 2002 TAX NOTES TODAY 45-19, (Jan. 30, 2002); ABA Comments in Response to Prop. Reg. 103580-02, 2003 TAX NOTES TODAY 213-21 (Oct. 9, 2003); Karen Burke, *Taxing Partnership Options*, 100 TAX NOTES (TA) 1569 (2003); Walter Schwidetzky, *The Proposed Regulations on Noncompensatory Options, A Light at the End of the Tunnel*, 21 J. TAX'N OF INV. 155 (2004).

¹⁵⁶See *supra* text accompanying notes 122-123.

have a takeover as their exit strategy. Section 368 smiles on takeover transactions.¹⁵⁷ For example, the merger of the target into the publicly held corporation can be tax free.¹⁵⁸ So can the exchange of the stock of the target for voting stock of the publicly held corporation (a B reorganization).¹⁵⁹ Thus, the owners can convert an illiquid asset (stock of a closely held corporation) into a liquid asset, without paying a tax charge. The stock received in the publicly held corporation can eventually be sold (likely piecemeal) in a public market.¹⁶⁰

Can the taxpayer get to the same place starting with a partnership? Assuming a binding agreement with the publicly held corporation that will acquire the stock is in place before incorporation, probably not. Here, unlike the public offering scenario above, there are no helpful regulations to bail out the taxpayer. Further, Revenue Ruling 1970-140,¹⁶¹ now getting a little long in the tooth, under similar facts says the taxpayer fails section 351(a). In Revenue Ruling 1970-140, pursuant to a preexisting agreement, a taxpayer incorporated a sole proprietorship and then purported to swap the stock he receives on incorporation for the stock of a public corporation in a tax-free B reorganization.¹⁶² The Service concluded that the taxpayer's receipt of stock on incorporation of the sole proprietorship was "transitory and without substance for tax purposes. . . ." The Service reasoned that the two steps, the incorporation and the B reorganization, should be integrated, so that rather than an incorporation and a B reorganization, the taxpayer is simply seen as contributing property to the public corporation. This means that the 80% control test of section 351 has to be applied with regard to the public corporation. The taxpayer, of course, does not meet the 80% control test under these circumstances, and thus the gain or loss inherent in the contributed property is not sheltered by section 351(a). As restructured, there is a full taxable exchange of the taxpayer's property for the stock in the public corporation.¹⁶³

More recently, the Service in Revenue Ruling 2003-51 both affirmed and distinguished Revenue Ruling 1970-140, and surprisingly concluded that the

¹⁵⁷ See I.R.C. § 368; BITTKER & EUSTICE, *supra* note 10, § 12. Gain is recognized to the extent "boot" is received; in this context, boot is money and property other than qualifying stock.

¹⁵⁸ I.R.C. § 368(a)(1)(A). Gain is recognized (and sometimes dividend income is earned) to the extent of cash received. I.R.C. § 356. Basis of shares received is determined under Code section 358, a process which accounts for the cash received as well as the recognized gain and dividend income.

¹⁵⁹ I.R.C. § 368(a)(1)(B).

¹⁶⁰ See 17 C.F.R. § 230.145 (2008).

¹⁶¹ Rev. Rul. 1970-140, 1970-1 C.B. 73. Here the taxpayer started with a sole proprietorship instead of a corporation, but the principle is the same.

¹⁶² I.R.C. § 368(a)(1)(B); Rev. Rul. 1970-140, 1970-1 C.B. 73. I simplify the facts. Actually, the taxpayer transferred the assets of the sole proprietorship to an existing corporation wholly owned by the taxpayer. Rev. Rul. 1970-140, 1970-1 C.B. 73.

¹⁶³ There is no tax consequence to the public corporation. I.R.C. § 1032.

control test of section 351(a) was met, notwithstanding a pre-incorporation binding agreement to dispose of the stock, if the taxpayer could have gotten to the same end result tax free using a different series of steps.¹⁶⁴ In the takeover transactions I posited above, that would not be possible. However, Revenue Ruling 2003-51 tantalizingly suggests that section 351(a) could apply to the first step in the takeover transactions I described above.

Treating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in I.R.C. § 351 is not necessarily inconsistent with the purposes of I.R.C. § 351.¹⁶⁵

Taken alone, this language might suggest that incorporating a partnership and having the resulting corporation engage in, for example, a B reorganization passes muster, notwithstanding the existence of a pre-incorporation binding agreement for the reorganization. The problem is that the quoted language cannot be read in isolation. Revenue Ruling 1970-140 involved an incorporation followed by a previously agreed upon B reorganization. Revenue Ruling 2003-21 does not revoke Revenue Ruling 1970-140.

Accordingly, the quoted language is either (1) the result of sloppy drafting, or (2) an indication of where the Service wants to go, though it does not have the intestinal fortitude to go there yet.¹⁶⁶

There are no cases contrary to Revenue Ruling 1970-140.¹⁶⁷ Therefore, owners of a partnership wanting to be the target of a takeover and wanting to have a binding agreement for the takeover before incorporation either have to live with taxable gain on incorporation (*i.e.* usually be, from a tax perspective, suicidal), or be willing to take their chances that Revenue Ruling 1970-140 no longer represents the Service's position. If, on the other hand, there is no binding agreement for the takeover before incorporation, the incorporation should be able to fall within section 351(a). Depending on how literally the Service and the courts apply the binding agreement test, a partnership may be able to make substantial progress toward negotiating the takeover, and then bring it to closure after incorporation. Having the takeover agreement fully prepared and then simply signing it after incorporation might be pushing the binding agreement test past the breaking point. The partnership and its partners could not be confident with facts that extreme that the courts will stay

¹⁶⁴ Rev. Rul. 2003-51, 2003-1 C.B. 938.

¹⁶⁵ *Id.*

¹⁶⁶ While I follow the Service's lead in focusing on section 351, there is also a substance-over-form or step transaction argument, or both, that the taxpayer in Revenue Ruling 1970-140 did not engage in a valid B reorganization. The argument would be that, at essence, what was involved was a swap of assets for stock in the public corporation rather than stock for stock as required by section 368(a)(1)(B). See BITTKER & EUSTICE, *supra* note 10, § 12.04. The solution I propose would effectively address this issue as well. See *infra* text accompanying notes 175-186.

¹⁶⁷ Indeed, one case is consistent with Revenue Ruling 1970-140. See *W. Coast Mktg. Corp. v. Commissioner*, 46 T.C. 32 (1966). As discussed *supra* note 122, *West Coast* is of dubious authority.

with the literal language of the binding agreement test as enunciated by the Tax Court. Of course, as noted above, life is much simpler if the owners start with an S corporation. The incorporation of the S corporation will almost always be old and cold before the section 368 reorganization happens.

d. *Section 1244.* A minor benefit for C and S corporations is section 1244. It permits losses on the sale or exchange of corporate stock (normally a capital asset) to be treated as ordinary losses rather than capital losses.¹⁶⁸ Capital losses are deductible from capital gains. In addition, individuals may deduct up to \$3,000 of any excess of capital losses over capital gains from ordinary income.¹⁶⁹ Ordinary losses are generally fully deductible, subject to the at-risk rules of section 465 and the passive loss rules of section 469. However, the aggregate amount that can be treated as an ordinary loss under section 1244 is not huge, \$50,000 per year for an individual, \$100,000 for a husband and wife filing jointly.¹⁷⁰ Section 1244 also only applies to stock issued by a corporation that qualifies as a small business corporation at the time the stock was issued. A small business corporation is one with no more than \$1 million of capitalization.¹⁷¹ Finally, section 1244 tends to be less valuable for S corporations than C corporations, as losses flow through to the shareholders in an S corporation,¹⁷² meaning that often there will not be much stock tax basis left to generate losses on a sale or exchange. As partnerships also permit losses to flow through to partners,¹⁷³ there is no crying need, or indeed much justification, for some kind of partnership tax analog to section 1244 in a non-Subchapter S world.

3. *Smoothing the Corporate Pathways*

Serious problems with partnership incorporations currently exist primarily when the incorporations are followed by some form of section 368(a) reorganization. I discuss the justification for permitting incorporations to be followed by reorganizations in more detail below, but before I discuss the "why" of it, I will discuss the "how" of it.

It is at least theoretically possible for the Code to permit partnerships to engage in tax-favored reorganization transactions with corporations directly. But that would require penning a parallel reorganization system. The current corporate system is of long standing and incorporates substantial anti-abuse provisions.¹⁷⁴ Rather than create a parallel system, it is simpler and more elegant to amend section 351(a) to provide that its control test is met even if the incorporation is followed by a section 368 reorganization or other tax-favored transaction, whether or not there is a binding agreement to enter

¹⁶⁸ I.R.C. § 1244(a).

¹⁶⁹ I.R.C. § 1211(b).

¹⁷⁰ I.R.C. § 1244(b).

¹⁷¹ I.R.C. § 1244(c)(1)(A), (c)(3)(A).

¹⁷² See *supra* text accompanying notes 36–45.

¹⁷³ See *supra* text accompanying notes 62–65.

¹⁷⁴ See BITTKER & EUSTICE, *supra* note 10, § 12.21.

into the subsequent transaction at the time of incorporation.¹⁷⁵ This approach means that taxpayers will have to go through the inconvenience of forming an often transitory C corporation, but the burden on the taxpayers is small when compared to the burden to the tax system generally if a parallel reorganization system is created.

Additionally, the section 368 reorganization provisions should be amended to make clear that they apply even if the participating corporation has recently incorporated. This amendment is necessary to deal with an attack from the other end of the transaction. While the focus to date has been on section 351, there also could be an argument, for example, that the B reorganization stock-for-stock swap rules are not met if the stock comes from a recently incorporated partnership. The Service could argue the flip side of Revenue Ruling 1970-140, that in substance the acquiring corporation is not swapping its stock for stock, but its stock for assets.

But the statutory change should go further. Incorporations followed by public offerings and ESOP-type structures appear to be safe now, but the authority for the current treatment could be stronger. The binding agreement test, for example, comes out of the Tax Court. Judges on other courts can disagree or the Tax Court can change its mind, or both. A more hard-wired set of rules to help integrate Subchapters S and K is preferable. The rules of Revenue Ruling 1984-111, the current regulatory rules for public offerings, and the binding agreement test should be made statutory, except that, as noted above, section 351(a) applies even if there is a binding agreement to engage in a reorganization transaction after incorporation.

One might ask why not permit an unrestricted tax-free incorporation, with no limits on what the taxpayer can do with the stock after incorporation. But, as I discuss in more detail below, section 351 provides tax-favored treatment because the taxpayer is, essentially, continuing his investment in a different form. If all or most of the stock is presold, what is really taking place is a sale of the incorporated assets and not a bona fide conversion to the corporate form. Pre-incorporation binding agreements that provide that after incorporation there will be public offerings or corporate reorganizations are inoffensive as the assets stay in corporate solution. But if the substance of the agreement is a sale of the assets, the substance should control. Of course, some taxpayers may negotiate the sale of the stock, then incorporate, and then promptly sell

¹⁷⁵I would include "divisive reorganizations" under section 355 within this rule. See BITTKER & EUSTICE, *supra* note 10, ¶ 11. Revenue Ruling 1970-140 actually applied a contribution of property to an existing corporation followed by a B reorganization. This too should qualify under an amended section 351(a).

H.R. 4137, discussed *infra* at notes 291 to 308, took a more limited approach, and would have amended section 351 to provide that the step transaction and similar doctrines do not apply for purposes of determining the section 351 control requirement in any case in which a partnership that is actively engaged in a trade or business transfers substantially all of its property to a nonpublicly traded corporation, if that corporation then enters into a reorganization.

the stock. But that problem exists under current law and the current law rules of substance over form remain available to address the problem.

As to the “why” of allowing partnership incorporations to be immediately followed by reorganization transactions: Courts have noted that section 351 is intended to apply where “there has been a mere change in the form of ownership.”¹⁷⁶ The taxpayer has not truly “cashed in on the theoretical gain”¹⁷⁷ Similarly, the legislative history to the predecessor of section 351 notes that the legislation provides new rules for “those exchanges or ‘trades’ in which, although, a technical ‘gain’ may be realized under the present law, the taxpayer actually realizes no cash profit.”¹⁷⁸ This continuity of investment principle also applies in the section 368 reorganization context.¹⁷⁹ Partners who incorporate a partnership and then engage in a section 368 reorganization have not, it can be defensibly argued, “cashed in on their theoretical gain” either. The question, in other words, is if a section 351(a) transaction can be tax favored and a section 368 reorganization can be tax favored,¹⁸⁰ why not permit the two to happen in quick succession and be tax favored?

In other contexts, the Code permits taxpayers to string tax-favored transactions together. There is no limit on the number of section 351 transactions, section 721 transactions, section 368 reorganizations, and like-kind exchanges under section 1031 that a taxpayer can do. Partners can form partnerships tax free and liquidate partnerships tax free as often as they want. The better, or at least more precise, question is not how many tax-favored transactions can be strung together, but does each Code section allowing a tax-favored transaction make sense on its own terms. To the extent it does, the fact that a taxpayer can engage in several tax-favored transactions in a row need not be offensive. For the two sets of Code provisions under discussion, section 351 and section 368, they indeed usually do make sense independently as the taxpayer’s investment is being continued, and thus allowing them to be done in quick sequence is not inherently objectionable.

Does the analysis change if one goes from holding a large illiquid interest in one entity to a small, liquid interest in a publicly held corporation? Here one has not just changed the form of the investment; one has to a great extent changed its fundamental nature. Yet that is currently allowed. One can merge one’s closely held corporation into a Fortune 500 company on a tax favored basis,¹⁸¹ and mergers are just one of several types of reorganizations in section

¹⁷⁶ *Stewart v. Commissioner*, 714 F.2d 977, 987 (9th Cir. 1983).

¹⁷⁷ *Id.*; see also *Hempt Bros. v. United States*, 490 F.2d 1172, 1177 (3d Cir. 1974).

¹⁷⁸ S. REP. NO. 275, 11–12 (1921).

¹⁷⁹ See BITTKER & EUSTICE, *supra* note 10, § 12.01[1]. There is an assumption that a section 355 transaction is, in fact, a type of reorganization; see Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 540; BITTKER & EUSTICE, *supra* note 10, § 11.01[1], [2].

¹⁸⁰ I use the term “tax favored” instead of “tax free,” as gain can be recognized. See I.R.C. § 354.

¹⁸¹ See I.R.C. § 368(a)(1)(A).

368 that permit this result.¹⁸² If these transactions are to be permitted generally, and I see no prospect for this changing, they should be permitted for partnerships that incorporate shortly before the section 368 reorganization.

Cooperation from the states is also required. As discussed earlier, in many states, incorporating a state law partnership or LLC can pose major challenges.¹⁸³ State transfer taxes may apply, and consent by landlords and banks to the transfer of assets may be required, etc.¹⁸⁴ What are needed are conversion statutes. They already exist in many states.¹⁸⁵ Under such a statute, a state law partnership or LLC can convert into a state law corporation while being considered the same entity for state law purposes. This will avoid asset transfer issues.

Where the intention is to take the business of the LLC public, an alternative solution to the state-level problem would be to persuade the market to accept publicly traded LLCs. Then no state law conversion would be needed. The LLC-partnership could convert for tax purposes to an LLC-corporation. Revenue Ruling 1984-111 or its statutory equivalent would need to be amended to make clear which of the "Options" would apply on such a conversion, but generally the transaction should be tax free.¹⁸⁶ Publicly traded LLCs already exist. The difficulty with this approach is the market for publicly traded securities is accustomed to dealing with C corporations as an overarching entity. As noted in the venture capital discussion above,¹⁸⁷ the market is also accustomed to dealing with, and often prefers, C corporation ownership structures, including its classes of common and preferred stock. There will thus likely be resistance to the large-scale use of publicly traded LLCs.¹⁸⁸ Perhaps LLC statutes could be amended to permit owners to hold "common and preferred stock," but at that point it makes as much sense to simply have a state conversion statute.

4. *The Capital Gain Freeze*

Another advantage of an S corporation over a partnership is the so-called capital gain freeze technique. This normally presupposes a taxpayer who owns real estate that is a capital asset¹⁸⁹ with substantial, inherent long-term capital gains. If the property is sold before development, these gains are taxed at

¹⁸² See I.R.C. § 368(a)(1); BITTKER & EUSTICE, *supra* note 10, ¶ 12.

¹⁸³ See *supra* text accompanying note 129.

¹⁸⁴ See, e.g., MD. CODE ANN., TAX-PROP. § 13-201 et seq. (LexisNexis 2007).

¹⁸⁵ See BISHOP & KLEINBERGER, *supra* note 17, ¶ 12.14.

¹⁸⁶ See *supra* text accompanying notes 115–18.

¹⁸⁷ See *supra* text accompanying notes 129–31.

¹⁸⁸ See Fleischer, *supra* note 114, at 137; Goldberg, *supra* note 114, at 943.

¹⁸⁹ It is also possible for the property to be a section 1231 asset, which includes real property used in a trade or business. If a taxpayer's gains from section 1231 assets exceed his losses from those assets, all the gains and all the losses are generally characterized as long term capital gains and losses. I.R.C. § 1231. It is probably more common for the property to be a capital asset before it is developed.

favorable rates. In the case of raw land, for example, the rate is 15%.¹⁹⁰ If instead, the taxpayer subdivides and develops the land, selling the lots individually, all of the gain on the sales is ordinary income, including the gain inherent in the property before development. Property held for sale in the ordinary course of a trade or business does not qualify as a capital asset, even if it was a capital asset in the hands of the taxpayer previously.¹⁹¹

There is currently a solution to this unhappy state of affairs. Before development, the taxpayer can sell the property to an S corporation the taxpayer controls. The S corporation then develops and sells the lots. The S corporation's gain on the sale of the lots is ordinary income, but the predevelopment gain is locked in as long term capital gain to the taxpayer by dint of the taxable sale to the S corporation.¹⁹² The S corporation takes a fair market value basis in the property upon purchase.¹⁹³ It is very unlikely that the S corporation can be funded with sufficient cash to be able to pay for the property outright. Most likely the S corporation pays with promissory notes that are payable in the future as the S corporation collects revenues from the sale of the lots. Under the installment sale rules of section 453, normally the selling taxpayer only has to recognize his long-term capital gain as the notes are paid.¹⁹⁴ A heavily indebted corporation with a high debt to equity ratio sometimes has to worry about the debt being reclassified as equity.¹⁹⁵ This is not generally a problem in the S corporation context, however, as long as the debt meets the "straight debt safe harbor."¹⁹⁶

The taxpayer cannot achieve this result by selling the property to a partnership. Section 707(b)(2) treats a partner's gain as ordinary income if the partner sells property to a partnership which in the hands of the partnership is not a capital asset, and the partner directly or indirectly owns more than 50% of the capital or profits interest in the partnership.¹⁹⁷ The selling partner, perhaps with other related parties, normally controls the partnership, and the property in the hands of the partnership is not a capital asset as the partner-

¹⁹⁰I.R.C. § 1(h)(1)(C).

¹⁹¹See I.R.C. § 1221(a)(1); *Mauldin v. Commissioner*, 195 F.2d 714, 715 (10th Cir. 1952). Section 1237 contains a minor exception. I.R.C. § 1237.

¹⁹²I.R.C. § 1001(c).

¹⁹³I.R.C. § 1012.

¹⁹⁴See I.R.C. § 453(e) (explaining limitations that do not usually pose problems).

¹⁹⁵See BITTKER & EUSTICE, *supra* note 10, § 4.02.

¹⁹⁶See I.R.C. § 1361(c)(5). The debt must be sum certain payable on demand or on a specified date, the interest rate cannot be contingent on profits or the borrower's discretion, the debt cannot be convertible into stock, and the creditor must be an individual, an estate or trust that is qualified to be an S corporation shareholder, or a professional lender.

¹⁹⁷The constructive ownership rules of section 267 apply for purposes of determining whether a partner meets the ownership test. These rules would, for example, attribute partnership interests owned by certain family members to the selling partners. See I.R.C. § 707(b)(3).

ship uses it in the business of development.¹⁹⁸ Section 707(b)(2) is generally said to be designed to prevent tax arbitrage. The sale gives the partnership a fair market value basis in the property. The likely cost to the related partner seller is long term capital gains likely taxed at low rates. Further, the partnership can now depreciate the property from the new, higher basis.¹⁹⁹ At times, the tax benefits of the higher basis to the partnership offsets the tax cost to the related selling partner. The risk of tax arbitrage is highly unlikely when the sale is of real property. The depreciation rates for improvements to real property are quite long, 27½ years for residential property and 39 years for commercial property.²⁰⁰ Usually, only a mathematically-challenged partner accepts the tax burden of the sale gain today in exchange for a series of relatively small annual depreciation supplements to the partnership for many years in the future. Further, the real property involved in capital gain freezes probably is most often raw land, which is not depreciable at all. If the sale is of an apartment building which the parties want to convert to condominiums, the gain equal to depreciation previously taken is typically taxed at a fairly high rate, 25%, making the tax arbitrage more uneconomical and more unlikely.²⁰¹

It is not apparent why existing, inherent capital gains should be converted to ordinary income when the use of the property changes. It is appropriate for future appreciation to be taxed in a manner that is consistent with the nature of the new use, but not past appreciation. This raises the question of whether an overarching solution should be found that would apply across the board and not just in the partnership context.²⁰² That is worth considering, though it is beyond the scope of this Article.

To bring some rationality to subchapter K in this regard and further integrate Subchapters S and K, at a minimum section 707(b)(2) should be amended to provide that it only applies to sales of personal property. Thus, the capital gain freeze technique for real property could be implemented with a partnership.

¹⁹⁸ See I.R.C. § 1221(a)(2). The lots held for sale are also not capital assets. See I.R.C. § 1221(a)(1).

¹⁹⁹ Section 707(b)(2) overlaps with section 1239.

²⁰⁰ I.R.C. § 168(c).

²⁰¹ See I.R.C. § 167; *Simon v. Commissioner*, 68 F.3d 41, 46 (2d Cir. 1995); see also I.R.C. § 1(h)(1)(D).

²⁰² Why require any long term capital gain that arose while property was held as an investment to be converted into ordinary income when the property is converted to a different purpose? Why require taxpayers to go through the fiction of a sale? Well, in truth, there could be practical problems. In the classroom, we can make our numbers up, but in the real world it is hard to know with certainty what the value is at the time property is converted to another use. Also, how will the service know if property is truly being held for investment? The current rule effectively requiring a sale to an S corporation (and under my proposal to a partnership) has the advantage of setting a heralding, reportable event that the Service can audit and upon which it can reach an independent judgment. Another possible solution that does not require a sale is to require a minimum holding period for the property during the investment phase where no significant development takes place, perhaps five years, with an appraisal to be done at the time of conversion by an independently licensed and unrelated appraiser.

5. *The Medicare Tax Dodge*

Here I move from the defensible to the sometimes indefensible.²⁰³

a. *Some Background.* Section 1401 imposes a tax on “net earning from self employment” (NESE).²⁰⁴ The tax has two components. One component is for “old-age, survivors, and disability insurance,” commonly known as the Social Security.²⁰⁵ The tax is 12.4% of NESE. The maximum NESE to which it applies is \$102,000 in 2008.²⁰⁶ The other component is for “hospital insurance,” commonly known as Medicare, and is 2.9% of NESE and applies to all of a taxpayer’s NESE.²⁰⁷ There is no dollar limit.²⁰⁸

NESE is defined as “gross income derived by an individual from any trade or business carried on by such individual, less the deductions . . . attributable to such trade or business, plus his distributive share of income or loss . . . from any trade or business carried on by a partnership of which he is a member”²⁰⁹ NESE does not include certain kinds of passive income, including portfolio income, capital gain, and similar income (Excluded Income).²¹⁰ I will discuss this in more detail below, but note that in this definition *all* partnership income other than Excluded Income in NESE.

The Social Security and Medicare taxes apply differently to employers and employees. They apply to “wages,” that is, compensation to an employee for services rendered.²¹¹ The employer and the employee each pay one half of the Social Security and Medicare taxes. The total tax is the same as it is for the self-employed. Thus, the tax that the employer and employee each pay is 6.2% of wages for Social Security (up to the same \$102,000 maximum that applies to self employment income) and 1.45% of wages for Medicare (without a maximum).²¹²

A partner cannot be an employee of a partnership or receive wages from a partnership for services rendered.²¹³ Outside of Excluded Income, a gen-

²⁰³ “Indefensible” was once also the name of Warren Buffet’s private jet. It is now the “Semi-Defensible.”

²⁰⁴ I.R.C. § 1401.

²⁰⁵ I.R.C. § 1401(a).

²⁰⁶ This amount is adjusted for inflation; see Notice 2007-92, 2007-47 I.R.B. 1036.

²⁰⁷ I.R.C. § 1401(b).

²⁰⁸ Individuals are entitled to a trade or business deduction equal to one half of the self-employment tax. I.R.C. §§ 62(a)(1), 164(f).

²⁰⁹ I.R.C. § 1402(a).

²¹⁰ I.R.C. § 1402(a). Among the exclusions are certain rentals from real estate, most dividends, certain interest, and certain property gains (typically from the sale of capital assets). See I.R.C. § 1402(a)(1). Certain retirement payments are also excluded. See I.R.C. § 1402(a)(10).

²¹¹ The statutory phrase is “remuneration from employment.” See I.R.C. § 3121(a).

²¹² See I.R.C. §§ 3101, 3111; Notice 2007-92, 2007-47 I.R.B. 1036. Notwithstanding this division, there is evidence that employees bear the economic burden of the entire tax. They pay their own share directly and, in effect, the employer’s share through reduced wages. See HARVEY ROSEN, *PUBLIC FINANCE* 286 (7th ed. 2005).

²¹³ Rev. Rul. 1969-184, 1969-1 C.B. 256.

eral partner's distributive share of income is always NESE.²¹⁴ NESE does not include the distributive share of any limited partner other than guaranteed payments under section 707(c) for services rendered.²¹⁵ Note that a partner can hold both a limited and general partner interest, and section 1402(a) applies to each separately. The limited partner exception was added to prevent passive investors from obtaining Social Security coverage. Limited partners had originally been subject to Social Security and Medicare taxes to the same extent as general partners, but Congress was concerned that limited partnerships might be established as investment vehicles in order to obtain Social Security coverage and excluded limited partners in the late 1970s.²¹⁶ Who qualifies as a limited partner is not defined in the Code or Regulations, but it appears from the legislative history and the plain language of the statute that a state law limited partner is meant.²¹⁷ Thus, apparently all tax partners who are not state law limited partners, including LLC members, fall under the general NESE rule.²¹⁸

To summarize, all income from a trade or business (other than Excluded Income) of any partner (other than a limited partner) is NESE, regardless of the partner's participation in the business, regardless of the capital invested in the business, and regardless of the character of the business. It is thus very possible for a partner (other than a limited partner) to have NESE that is unrelated to any services performed by the partner.

One might think that both wages and NESE would measure the same thing, income earned from the provision of services. The fact that this is not the case has much to do with the history of the Social Security tax. The Social Security tax structure was originally centered on the employer-employee relationship.²¹⁹ In the early years, coverage extended only to limited groups of wage earners.²²⁰ The self-employed were not covered.²²¹ Thus, originally it was clear that the Social Security tax (the Medicare tax had not yet been created)²²² applied only to income from services. The self-employed originally resisted coverage, but then in the 1950s acquiesced partly due to the fact that meaningful coverage could be had at what at the time was still a low rate of

²¹⁴I.R.C. § 1402(a).

²¹⁵I.R.C. § 1402(a)(13).

²¹⁶See Patricia E. Diller, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65, 85 (2000).

²¹⁷See H.R. REP. NO. 95-702 at 40, 1978-1 C.B. 469, 477 (1977). At that time, only a state law limited partnership could be meant as LLCs and similar entities did not yet exist. See also David C. Culpepper et al., *Self-employment Taxes and Passthrough Entities: Where Are We Now*, 109 TAX NOTES (TA) 211, 212 (2005). The Service might be authorized to expand that definition. See *infra* text accompanying notes 230–238.

²¹⁸See Culpepper, *supra* note 217.

²¹⁹See Diller, *supra* note 216, at 70.

²²⁰*Id.*

²²¹*Id.* at 71.

²²²It was enacted in 1965. See Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286.

tax.²²³ Congress had been concerned about the administrative feasibility of including the self-employed within the Social Security system, particularly with regard to obtaining accurate reports of their income.²²⁴ These concerns were eventually laid to rest and the self-employed were included, but nothing in the legislative history suggests that Congress wanted the focus of the Social Security tax to move from a tax on income from services to a tax on income from services *and* capital. Further, at the time the self-employed were brought into the fold, much of the discussion seems to have centered on applying the Social Security tax to professionals such as doctors and lawyers, that is, service providers.²²⁵ Thus, when Congress brought the self-employed within the Social Security tax system, it likely thought that NESE primarily focused on income from services. Further, by excluding certain passive income and later income of limited partners (historically by definition passive participants), Congress made some effort to exclude from NESE certain kinds of income that are not from services.

Finally, there would have been little logic to expanding the Social Security tax to include income from capital. Why should the type of income subject to Social Security and Medicare taxes for employees be different than that for the self-employed? Employers and employees are not being rewarded for using double-tax C corporations, as S corporations, which also can have employees, are subject to the same employment tax rules as C corporations. S corporations have been on the scene since 1958 and conceptually since 1946.²²⁶ Further, the Social Security benefits one receives are a function of what one pays in.²²⁷ Why would Congress want the self-employed to have a larger base for benefits than employees? Whatever Congress's intent, Social Security and Medicare taxes should not apply to income from capital.

b. *Time Waits For No Congress.* Time has passed section 1402 by. There is not a lot of logic to its current structure in the current business universe. While self-employment taxes should focus on income from services, in an LLC universe NESE can, and often does, include much income that is from capital. There is no good reason why passive owners who are limited partners are not subject to self-employment taxes and passive owners who are LLC members are subject to self-employment taxes. Further, in an increasing number of states limited partners have increasing rights to participate in the affairs of the limited partnership,²²⁸ making their automatic exclusion from NESE dubious. The logic behind these dichotomies has not been apparent to

²²³ See Diller, *supra* note 216, at 71–74.

²²⁴ S. REP. NO. 1669 (1950); *see also* Yoder v. Harris, 650 F.2d 1170, 1173 (10th Cir. 1981) (discussing the relevant legislative history).

²²⁵ See Diller, *supra* note 216, at 71–74.

²²⁶ Pub. L. No. 85-866, 72 Stat. 1606 (1958); *see* RICHARD B. GOODE, THE POSTWAR CORPORATION TAX STRUCTURE (Treas. Dep't 1946).

²²⁷ See Diller, *supra* note 216, at 70.

²²⁸ See Unif. Ltd. P'Ship. Act § 303 (2001).

the Service either.²²⁹

In 1997, the Treasury proposed regulations in this area. This was one of several efforts I will outline that attempt to limit NESE to income from services, or at least reduce the amount of income from capital that is included in NESE. The Treasury faced a terminological challenge, in that it had to squeeze its regulations into the statutory general-limited partner structure. It did this by freeing the term "limited partner" in the tax statute from that term in state law statutes. Under the Proposed Regulations, a member of any state law entity that is classified as a partnership for federal income tax purposes can be treated as a limited partner for section 1402 purposes under some circumstances.²³⁰ The Proposed Regulations also partially address the overarching issue of when income is from services and when from capital.

The laudable objective of the Proposed Regulations is to insure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions are treated similarly.²³¹ The Proposed Regulations treat an individual as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.²³² Note that if a state law limited partner meets one of the three criteria, he is not a limited partner for section 1402 purposes.

If an LLC is "member-managed," all members have the apparent authority to contract on behalf of the LLC, irrespective of whether they hold multiple classes of interests or not.²³³ Consequently, no member of a member-managed LLC qualifies as a limited partner under the Proposed Regulations. On the other hand, in a manager-managed LLC, the managers have the exclusive authority to manage the LLC, and members who are not managers normally do not have any apparent authority to contract.²³⁴ Consequently, these non-managing members can qualify as limited partners as long as they do not fail the 500-hour test. By statute they have no general liability for the obligations

²²⁹ Some older private letter rulings treat a LLC member's share of income as NESE. See, e.g., P.L.R. 1994-32-018 (May 6, 1994); P.L.R. 1994-52-024 (Sept. 29, 1994); P.L.R. 1995-25-058 (Mar. 28, 1995).

²³⁰ Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997). These were preceded by Proposed Regulation section 1.1402(a)-18, 59 Fed. Reg. 67,253 (1994), which focused more on LLCs, as such.

²³¹ See Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1702 (1997) (see "Background").

²³² *Id.* The 500-hour rule is derived from the regulatory definition of material participation under the passive loss rules of section 469. See Reg. § 1.469-5T(a)(1).

²³³ See BISHOP & KLEINBERGER, *supra* note 17, § 7.02.

²³⁴ *Id.*

of the LLC; thus test (1) of the Proposed Regulations could not apply.²³⁵

The Proposed Regulations contain a special rule for services partnerships, under the assumption that virtually every one involved will be actively performing services. The Proposed Regulations provided that if substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides such services for the partnership cannot be classified as a limited partner, and thus all of his income is NESE (other than Excluded Income).²³⁶

The Proposed Regulations permit individuals to hold more than one class of interest in any partnership except a services partnership. A partner may bifurcate his interests, with some interests earning NESE, and other "limited partnership interests" not earning NESE.²³⁷ Thus, the treatment that is available today in a state law limited partnership, the Proposed Regulations make available to all nonservices tax partnerships.²³⁸ It is here that the Proposed Regulations make an initial attempt to tussle with the issue of when income is from services and when from capital. In effect, the Proposed Regulations are saying that for nonservices partnerships (irrespective of the state law classification) it is permissible to create a class of limited partnership interests to which non-NESE income can be allocated. This income can be viewed as coming from capital and not from services. While the Proposed Regulations are hardly comprehensive, they take a step in the right direction.

The Proposed Regulations were generally well received,²³⁹ but Congress imposed a moratorium, stating that they could not be finalized before July

²³⁵ A limited liability partnership (LLP) is a general partnership with a liability shield. Thus, its partners are general partners, and, in most states, have the authority to contract to the same extent as general partners in general partnerships, and thus also would not have qualified as limited partners under the Proposed Regulations irrespective of whether they hold multiple classes of interests or not. See Culpepper, *supra* note 217; see generally, BISHOP & KLEINBERGER, *supra* note 17, § 1.05.

²³⁶ Prop. Reg. § 1.1402(a)-2(h)(5), 62 Fed. Reg. 1702 (1997).

²³⁷ Under the Proposed Regulations, it is possible to qualify as a limited partner even if the partner participates over 500 hours and does not hold multiple classes of interest. For this rule to apply, limited partners (as normally defined under the Proposed Regulations) must own a substantial, continuing interest in the partnership, and the rights and obligations of the individual in question must be identical to those for the limited partnership class. The underlying presumption apparently is that the partner would be paid for her services, and the rest of any payment should be seen as return on capital. Note that the partnership would still have to have two classes of interest overall. Prop. Reg. § 1.1402-2(h)(4).

²³⁸ The Proposed Regulations, however, permit the bifurcation of interests only to the extent the individual's rights and obligations with respect to a limited partnership class of interest is identical to the rights and obligations of other partners in that class who (1) qualify as limited partners under the Proposed Regulations without regard to the bifurcation rules, and (2) own a substantial interest in the partnership. Prop. Reg. § 1.1402(a)-2(h)(3), -(h)(4).

²³⁹ See John R. Marquis, *Business Problems & Planning: Current Status of Limited Liability Companies and the Self-Employment Income Tax*, 77 MICH. B. J. 440, 441 (1998).

1, 1998.²⁴⁰ That date has come and gone without the Treasury taking any additional action on the Proposed Regulations, though they have not been withdrawn. Congress appears to have been concerned about the risk of existing state law limited partners being reclassified as other than limited partners for federal income tax purposes.²⁴¹ In fact, this risk was quite slight as most limited partners doubtless fail all three tests.²⁴² Further, in those cases where reclassification might happen, it is likely justified. Political pressure, not for the first time, may have taken precedence over sound tax policy, and to date the Treasury has not had the intestinal fortitude to take another run at it.

The difficulty with the Proposed Regulations is that they do not tackle the income-from-capital versus income-from-services issue head-on. Curiously, the Proposed Regulations provide backdoor endorsement of manager-managed LLCs, as they are the only unincorporated entity other than a state law limited partnership that can effectively create two classes of interests. LLCs are usually preferred to limited partnerships, as limited partnerships require two entities to achieve a full liability shield, the limited partnership itself and a corporation or LLC as the general partner.²⁴³ To muscle the nonservice universe into these two entities—few would want to use C corporations—is perhaps not the most sensible approach. On the other hand, the Service was bound by the limitations of the statute it was interpreting. The only “out” from NESE was the income allocated to a limited partner. Others have had a freer hand.

In 1998, the American Institute of Certified Public Accountants (AICPA), in response to the Proposed Regulations, suggested a statutory change.²⁴⁴ In broad outline, the AICPA’s proposed amendment provides that partners in tax partnerships have NESE to the extent of the reasonable value of the services performed on behalf of the partnership. It contains a safe harbor for determining the reasonable value of services. If a partner’s NESE varies from the safe harbor by more than ten percent, the NESE is subject to “reason-

²⁴⁰ See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (1997).

²⁴¹ See Culpepper, *supra* note 217, at 222.

²⁴² Congress itself partially acknowledged the truth of this in 1997. When discussing the passive loss rules, the Statement of Managers for the Taxpayer Relief Act of 1997 observes that limited partners usually do not materially participate in a partnership’s activities. H.R. Rep. No. 105-220, at 662 (1997) (Conf. Rep.), reprinted in 97 TAX NOTES TODAY 148-32 (Aug. 1, 1997); see also Culpepper, *supra* note 217.

²⁴³ In states that allow limited liability limited partnerships (LLLPs) it may be possible to get by with one entity, but only a minority of states allow for LLLPs, and most advisors will insist on a corporation or LLC as a general partner if the LLLP is going to be doing business in a non-LLLP jurisdiction. An LLLP is a limited partnership with a liability shield around the entire partnership so that even the general partners have limited liability. See generally BISHOP & KLEINBERGER, *supra* note 17, § 1.02.

²⁴⁴ AICPA Forwards Legislative Proposal on Self-Employment Taxes, 98 TAX NOTES TODAY 39-34 (Feb. 27, 1998) [hereinafter AICPA Proposal]. The Small Business Tax Modification Act of 2004, section 3, takes a similar approach to that of the AICPA (doubtless not by coincidence). See *infra* notes 281-300.

ableness testing on the basis of facts and circumstances. . . .” The safe harbor NESE is the partner’s distributive share of partnership income or loss *plus* the section 707(c) guaranteed payment for services *minus* a reasonable rate of return on the partner’s capital account at the beginning of the year. The rate of return on the partner’s capital account is deemed to be reasonable if the rate used is 150% of the applicable federal rate²⁴⁵ (AFR) at the end of the partnership’s tax year.

The proposal has several shortcomings. It does not except services partnerships, the most likely area of abuse, notwithstanding the fact that an objective review of most service partnerships would conclude that all or almost all of their income is NESE. What is worse, given the safe harbor, service partnerships have an incentive to inflate capital accounts to avoid NESE. This could be done by making cash contributions to the partnership and holding them in a money market account. Further, capital accounts are usually not precise measures of the value of partners’ invested capital.²⁴⁶ While they can under some circumstances be “restated” to current value, this is relatively uncommon.²⁴⁷ A partner’s capital account may lag far behind or move far ahead of the value of the partner’s partnership interest. Thus, a reasonable rate of return on the partner’s capital account may yield a meaningless number. Finally, while there is much to be said for bright, predicable lines, the 150% AFR standard is arbitrary. For some industries the 150% rate could be far high or far low.²⁴⁸ The AICPA provides for additional fudge room by permitting partners to vary from the safe harbor by ten percent. Of course, what the AICPA is likely trying to do is limit partners’ NESE as much as practicable.

In 2005, the Joint Committee of Taxation (JCT) also proposed a statutory change.²⁴⁹ This proposal eliminates the special rule for limited partners and applies to all tax partnerships. All income, including Excluded Income, is NESE in the case of a partnership engaged in the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (professional services). For other partnerships, how a partner is treated is a function of whether or not the partner “materially

²⁴⁵ The Service sets short-term, mid-term, and long-term applicable federal rates monthly. *See, e.g.*, Rev. Rul. 2008-43, 2008-31 I.R.B. 258. Curiously, the AICPA report does not specify which of these three applicable federal rates it would use. *See AICPA Proposal, supra* note 244.

²⁴⁶ Under the Regulations, capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. Reg. § 1.704-1(b)(2)(iv)(b).

²⁴⁷ *See* Reg. § 1.704-1(b)(2)(iv)(f).

²⁴⁸ *See* Letter from George K. Yin, Acting Chief of Staff, Joint Committee on Taxation, to Senators Charles E. Grassley and Max Baucus, at 34, (Aug. 3, 2006) [hereinafter JCT 2006], *available at* <http://www.senate.gov/~finance/press/Gpress/2005/prg101906.pdf>.

²⁴⁹ STAFF OF J. COMM. ON TAX’N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 99 (2005), *available at* <http://www.house.gov/jet/s-2-05.pdf>. I do not discuss their S corporation proposals, as they are moot under my proposal.

participates" in the partnership.²⁵⁰ If the partner materially participates, all income other than Excluded Income is NESE. If the partner does not, only his reasonable compensation for services rendered is NESE.

This JCT proposal has a few problems. One of them is the provision that Excluded Income is NESE for professional services partnerships. This is a curious change and, as I discuss below, one from which the JCT ultimately backs away. To take one example of Excluded Income to make the point, dividends that a professional service partnership receives are not likely to be somehow "tainted." If dividends should not normally constitute NESE, and since they are not normally compensation for services they should not, there is no apparent reason they should be NESE to a services partnership. Since Excluded Income is easily identified, and needs to be identifiable for non-services partnerships regardless, there is no great additional administrative burden by continuing the exclusion for services partnerships.

Aside from the Excluded Income issue, providing that all income of a services partnership is NESE makes good sense. In a small minority of cases, a services partnership may legitimately have income from capital. There may occasionally be a partner who does not significantly participate in the affairs of the partnership, though he probably did at some point. But it is likely that in an overwhelming majority of services partnerships, an objective analysis would reveal that all the income (other than Excluded Income) is NESE. A rule which makes that real world reality the tax reality is difficult to attack. Trying to except out special cases for income from capital or income of low-participation partners helps few and creates opportunities for abuse, as well as consequent enforcement challenges. Partners would claim income came from capital when it did not, or claim that they participated less than was in fact the case. The Service would have to spend time dealing with the misguided. It all would not be worth the effort. It is not clear, however, why the JCT focused just on professional services partnerships. It seems that the issues would be the same for any services partnership.

Treating all of a partner's income from a nonservices partnership as NESE if a partner materially participates is difficult to justify. A partner might materially participate in a capital intensive partnership where most of the income of the partnership comes from the capital invested, not the partner's services. Furthermore, since services partnerships are already off the table, this rule is very likely to catch situations where the income from capital is substantial. The JCT proposal does have the advantage of providing a bright line, which can provide for administrative ease, but its bright line is too divorced from reality.

²⁵⁰The material participation standards were created by section 469, the passive loss rules. An activity generally is not passive with regard to taxpayer if he materially participates in it. See I.R.C. § 469(c)(1). The Regulations contain various ways in which a taxpayer may materially participate, for example, by participating more than 500 hours during the taxable year. See Temp. Reg. § 1.469-5T(a).

In 2006, the JCT proposed a modified version of its 2005 proposal. It essentially drops, or at least no longer lobbies for, its nonservices partnership proposal. It keeps its services partnership proposal, except that Excluded Income is no longer NESE.²⁵¹

The American Bar Association Tax Section has taken several runs at this issue. I will focus only on the most recent effort, if for no other reason than I participated in the task force that prepared the Section's comments.²⁵²

In its comments, which are fairly brief, the Tax Section unsurprisingly applauds the fact that the JCT dropped its treatment of Excluded Income of services partnerships as NESE.²⁵³ The Tax Section, however, objects to the "wholesale expansion" of the income treated as NESE.²⁵⁴ It is not clear to what expansion the Tax Section is referring. The real expansion is occurring because an unchanged section 1402 is applying to a broader range of businesses and thus a broader range of income, and is not coming from the JCT.²⁵⁵ The Tax Section argues that for both service and nonservice partnerships, the most appropriate rule is to treat as NESE only that portion of the net income of a partnership that represents reasonable compensation for services rendered.²⁵⁶ The Tax Section recommends that if the JCT approach for service partnerships is adopted, an exception for "de minimis service partners" be created for those who provide low amounts of services.²⁵⁷ Under the Tax Section proposal, NESE for de minimis service partners consists of guaranteed payments as well as the partners' distributive share of income generally, but in the latter case only to the extent it constitutes reasonable compensation for services rendered.²⁵⁸ With regard to nonservices partnerships, the Tax Section argues "strongly" that NESE be limited to an amount that constitutes reasonable compensation, as income also will come from capital.²⁵⁹ Should that be considered to be administratively unworkable, the Tax Section recommends a complex proposal that includes guaranteed payments as NESE.²⁶⁰ Additionally, a "material participation partner's" distributive share of income (other than Excluded Income) [is] NESE to the extent of reasonable compensation for services. . . ."²⁶¹ The Tax Section further recommends that there

²⁵¹ See JCT 2006, *supra* note 248.

²⁵² See ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax, 1999 TAX NOTES TODAY 133-23 (July 6, 1999).

²⁵³ See ABA SECTION OF TAXATION COMMENTS ON ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE PREPARED BY THE STAFF OF J. COMM. ON TAX'N 7 (Aug. 3, 2006) [hereinafter ABA COMMENTS]. I do not address the S corporation proposals, as they are mooted by my proposal.

²⁵⁴ See *id.*

²⁵⁵ See *supra* text accompanying notes 206-227.

²⁵⁶ See ABA COMMENTS, *supra* note 253 at 7.

²⁵⁷ See *id.* at 8.

²⁵⁸ *Id.*

²⁵⁹ *Id.* at 43.

²⁶⁰ *Id.* at B-1.

²⁶¹ *Id.* at 9.

be a rebuttable presumption that guaranteed payments and the distributive share are NESE up to a "presumption amount;" the Tax Section suggests that the maximum income to which the Social Security tax is applied (\$102,000 in 2008²⁶²) be that presumption amount.²⁶³ As I discuss below, it has become common for advisors to S corporations to recommend that shareholder-employees only take the Social Security tax maximum as a salary and let the rest of the S corporation's income "flow through" as nonwage income. (Elsewhere in its comments, the Tax Section endorses this approach.) The Tax Section is attempting to obtain official sanction for a practice that likely usually understates compensation. If the Social Security tax maximum is the presumption amount, it is a safe bet that the vast majority of partners will limit their compensation to be the presumption amount, and large amounts of what should be compensation income will escape Social Security and Medicare taxes. Congress and the Service should not entertain such an invitation to end run the Social Security and Medicare tax system, particularly given the financial difficulties in which Social Security and Medicare find themselves.²⁶⁴

I propose amending section 1402 to catch it up with the real world. I discuss my proposal in terms of partnerships, but would apply it to disregarded entities-sole proprietors as well. What the JCT and the Proposed Regulations do wisely, and will go a long way toward limiting abuse, is to carve out a special rule for partnerships primarily engaged in the performance of services. I agree with the JCT that all income of a services partnership (except Excluded Income) should be classified as NESE. While it is certainly possible that a given service partnership has a substantial investment in capital, allowing service partnerships to allocate earnings to capital opens the door wide for abuse. As I noted above, for the vast majority of service partnerships, capital is mostly likely not a large income producing factor. Additionally, there may occasionally be partners in service partnerships who provide little in the way of services, but they likely once did if the partnership is allocating income to them. Further, the income that is being allocated to them is, most likely, from someone's performance of services. By the mere expedient of shifting income from active to inactive partners, Social Security and Medicare taxes should not be avoided. Treating all income (other than Excluded Income) from service partnerships as NESE will create little unfairness, while avoiding many shenanigans, and reducing the enforcement burdens of the Service. The Proposed Regulations and the JCT, however, limit the rule for service partnerships to those engaged in the performance of professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. Yet the underlying policy issues apply to any service partner-

²⁶² This amount is adjusted for inflation. See Notice 2007-92, 2007-47 I.R.B. 1036.

²⁶³ See ABA COMMENTS, *supra* note 253 at 9.

²⁶⁴ See generally *Social Security: Achieving Sustainable Solvency: Hearing Before the S. Comm. on Finance*, 109th Cong. 1-17 (2005) [hereinafter Senate Finance Hearing], available at <http://finance.senate.gov/hearings/27402.pdf>.

ship, so I would apply my proposal to any service partnership, not just those engaged in the specified professions. My broader approach creates the need to formally define a services partnership. A reasonable definition is any partnership less than 20% of the gross income of which is attributable to nonhuman capital.

For nonservice partnerships, I largely agree with the Tax Section. Anyone performing services for a nonservices partnership should be required to be paid reasonable compensation for those services, and that amount should be NESE. I have no "presumption amount" which, as I noted above, will commonly lead to improper tax avoidance. I treat partnership income in excess of reasonable compensation as income from capital and not as NESE.

The reasonable compensation for services standard may seem unduly vague, and indeed will create administrative burdens, but in fact it has been one we have lived with for generations. It had been regularly applied in the C corporation context.²⁶⁵ Commonly there, shareholder-employees have attempted to avoid the C corporation double tax by paying themselves a large salary. They argued that as salary, the payment is income to the recipient, deductible to the corporate payor, and thus (they hoped) subject to one level of tax.²⁶⁶ Courts have analyzed these purported salary payments under various standards, and if they concluded the salary was unreasonably high, reduced it, with the excess being reclassified as a nondeductible dividend.²⁶⁷ There have also been occasions where the courts have looked at whether a salary is too low, as I will discuss below.

Admittedly, allowing courts to resolve compensation issues creates inefficiencies and uncertainties. In a given set of circumstances, taxpayers will not be able to be completely certain if their allocation between compensation and a return on capital will be respected, and it might encourage some to play the audit lottery in the hopes that their abusive scheme will not be uncovered. But the reality is that a fixed rule like that of the JCT for nonservices partnerships often will be far of the mark. What is appropriate compensation varies greatly based on the amount of capital involved, the extent of the services provided, the nature of the industry involved, and doubtless a host of other factors. The inequity of a fixed rule in the nonservices partnership context argues for a more general standard. Further, the fact that all income (other than Excluded Income) of service partnerships is automatically NESE will ease the administrative burden on the Service and the courts, providing

²⁶⁵ *Menard, Inc. v. Commissioner*, 2009-1 U.S.T.C. ¶ 50,270, 103 A.F.T.R.2d 1280 (7th Cir. 2009); *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

²⁶⁶ See *Menard*, 2009-1 U.S.T.C. ¶ 50,270, 103 A.F.T.R.2d 1280; *Exacto*, 196 F.3d at 833; I.R.C. § 162(a).

²⁶⁷ See *Exacto*, 196 F.3d at 833 (7th Cir. 1999) (analyzing the reasonableness of the salary based on whether an adequate return was being paid to the shareholders on their investment); *Owensby & Kritikos v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) (applying a multiple-factor test); see also *Haffner's Serv. Stations v. Commissioner*, 326 F.3d 1 (1st Cir. 2003) (applying factors but acknowledging the legitimacy of the *Exacto Spring* decision).

something of an offset.

c. *The Scofflaw Gambit.* The current definition of NESE means that a taxpayer who wants to avoid Social Security and Medicare taxes will not find the partnership soil very fertile. Ah, but an S corporation, that is a very different matter. While a partner may not be an employee of a partnership,²⁶⁸ there is nothing to keep a shareholder from being an employee of a corporation, whether it be a C corporation or an S corporation. Employers and employees are only assessed Social Security and Medicare taxes on the compensation that is paid to the employee.²⁶⁹ That fact gives rise to the following tax avoidance technique using S corporations. The S corporation pays a modest salary or perhaps no salary at all to its shareholder-employees. The net income of the S corporation not used to pay salaries "flows through" under the regular S corporation section 1366 rules, arguably as noncompensation, and therefore arguably not subject to Social Security and Medicare taxes.

This gambit has been going on for many years. I spoke about it at CLE seminars some 15 years ago, and advised participants not to form S corporations just for this purpose, as the Service would likely close this loophole soon. No one on the panels ever disagreed. We were less than prescient. The Service has failed to sufficiently police this area. Taxpayers have used S corporations to avoid both Social Security taxes and Medicare taxes. Since Social Security taxes are only applied to limited amounts of compensation (\$102,000 in 2008²⁷⁰), S corporation shareholders have to pay themselves relatively low salaries or no salaries to save these taxes. And, in fact, they have done so. The Service has challenged the most piggish gambit users, those that have paid themselves little or no salary. The Service has won all of these cases. Courts have generally concluded that the earnings of the S corporation constituted compensation to the shareholder-employees, either under a substance over form analysis or by concluding that the distributed earnings constituted reasonable compensation for the services rendered.²⁷¹

²⁶⁸ Rev. Rul. 1969-184, 1969-1 C.B. 256.

²⁶⁹ See *supra* text accompanying notes 211-17.

²⁷⁰ This amount is adjusted for inflation. See Notice 2007-92, 2007-47 I.R.B. 1036.

²⁷¹ See *Nu-Look Design v. Commissioner*, 356 F.3d 290 (3d Cir. 2004); *Specialty Transp. and Delivery Servs. v. Commissioner*, 2004-1 U.S.T.C. ¶ 50,203, 93 A.F.T.R.2d 1374 (3d Cir. 2004); *Spicer Accounting v. United States*, 918 F.2d 90 (9th Cir. 1990); *Dunn & Clark P.A. v. Commissioner*, 853 F. Supp. 365 (D. Idaho 1994); *Radtke S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), *aff'd* 2004-1 U.S.T.C. ¶ 50,209, 93 A.F.T.R.2d 2004-1273 (3d Cir. 2004); *W. Mgmt. v. United States*, 45 Fed. Cl. 543 (Fed. Cl. 2000); *Joly v. Commissioner*, 76 T.C.M. (CCH) 633, 1998 T.C.M. (RIA) ¶ 98,361. In these cases, the courts often focused on distributed earnings, and typically most or all of the earnings were distributed. Distribution should not change the analysis. If the S corporation earnings are indeed best classified as compensation to the shareholder-employees, whether or not they are distributed in a given year should not change the answer. Typically, the shareholder-employees have full control over timing. See also *Charlotte's Office Boutique v. Commissioner*, 121 T.C. 89 (2003), *aff'd*, 425 F.3d 1203 (9th Cir. 2005).

Curiously, the Service has never litigated nor expressed an opinion on the more temperate taxpayer who has the S corporation pay her a moderate salary.²⁷² For example, in 2008 a neurosurgeon with \$1 million of net S corporation income (before salaries) might pay herself the Social Security income maximum of \$102,000 as a salary, and let the rest of the income flow through as noncompensation. She thus saves the Medicare tax of $2.9\% \times \$898,000 = \$26,042$.²⁷³ And she is a happy woman. I choose the \$102,000 Social Security maximum for a reason. Some advisors are routinely telling their clients to pay this amount to themselves as salary, and to treat the balance of the S corporation income as noncompensation.²⁷⁴ One of my own doctors told me he takes this approach, and clearly is under the impression that he is not obligated to pay himself more than the Social Security maximum as salary.

In a pure services S corporation, through which, for example, a doctor or a lawyer practices her profession, this is obviously abusive. Most likely, if litigated, a court will find all or almost all of the S corporation's income to be compensation for services as they have in the admittedly more "hoggish" cases that have been litigated to date.²⁷⁵

In the closely held corporation context, courts generally have required corporations to pay reasonable compensation to their shareholder-employees.²⁷⁶ Continuing with the neurosurgeon example, all of the income of the S corporation is attributable to her services. Therefore, normally reasonable compensation is all of the net income of the S Corporation. Reasonable com-

²⁷² See H.R. 3970, 110th Cong. § 1211 (2007) (attacking the totality of the problem within the S corporation context).

²⁷³ Easily the most famous person to use this technique was former senator, vice presidential nominee, presidential candidate, and bon vivant John Edwards. Over four years (1995–1998), on income of about \$27 million, he saved Medicare taxes of over \$590,000. See Michael Moss & Kate Zernike, *Campaign Releases Edwards's Earnings*, N.Y. TIMES, Jul. 10, 2004, at A-1. The journalism on this news story left something to be desired. The technique was portrayed as a legitimate "tax shelter." *Id.* If challenged, a court most likely would have held almost all of the S corporation income to be compensation. The specifics: Edwards apparently incorporated mid-way through 1995. In that year he paid himself a salary of \$180,000 on income for the year (including pre-incorporation) of \$5 million. In 1996, the S corporation earnings were \$4 million and Edwards received a salary of \$360,000. In 1997, the S corporation earnings were \$11 million and Edwards received a salary of \$360,000. In 1998, his final year of law practice, the S corporation earnings were \$5.5 million with the same \$360,000 salary. See Tom Daley, *Edwards's S Corp: Can We Get the Numbers Right?*, 2004 TAX NOTES TODAY 178-32 (Sept. 13, 2004). The total earnings reported in the Daley piece are somewhat less than in the N.Y. Times Article (\$25.5 million versus \$27 million). I have not found a source for this, but I have heard that the \$360,000 salary was based on what the average personal injury lawyer makes in North Carolina, the state where Edwards practiced law. See also, Kip Dellinger, *Edwards's S Corp: The Revised Numbers are Still Absurd*, 2004 TAX NOTES TODAY 183-33 (Sept. 20, 2004).

²⁷⁴ I have not come across written evidence of this, but it is often implied. See, e.g., Alan L. Olson, *Ten Tax Planning Ideas for Small Business in 2009*, http://www.groco.com/reading-room/tax_smallbusiness.aspx (last visited Apr. 3, 2009).

²⁷⁵ See *supra* note 271.

²⁷⁶ See *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999); *Joly*, 76 T.C.M. (CCH) at 633, 1998 T.C.M. (RIA) ¶ 98,361 at 2148.

pensation must be based on the value of the neurosurgeon herself and not, say, the value of the average neurosurgeon. Otherwise the top neurosurgeon in a state making five times the average could argue that her compensation should be based on what the average neurosurgeon earns, or one fifth of what she is actually earning. That would be an easy way to save Medicare and possibly Social Security taxes. But if that top neurosurgeon went to work for a bona fide employer, she would not accept the average wage, she would insist on being compensated for her actual worth. That is her reasonable compensation, or in the typical case, all of the net income of the S corporation. What makes this argument even more persuasive is the fate of the below average neurosurgeon. Should a neurosurgeon whose S corporation earns less than the average be deemed to have compensation equal to the average? Obviously, that would make no sense.

There might occasionally be an argument that there is a sufficient capital investment so that a small percentage of the income is allocable to capital. But clearly what is usually going on is an effort to make an end-run around the Medicare tax and Social Security tax systems. It is axiomatic that substance controls form,²⁷⁷ and likely in the vast majority of cases²⁷⁸ the substance is that all of the net income of the S corporation constitutes the earnings of the service provider, the S corporation form only being used for the purpose of lowering Medicare or Social Security taxes, or both.

Senator Wyden, an Oregon Democrat, calls those who make such inappropriate use of S corporations "Social Security Scofflaws."²⁷⁹ The cost to the fisc from this technique is not insubstantial. The underpayment of Medicare and Social Security taxes through the use of S corporations is estimated to be about \$6 billion per year for each tax, or about \$12 billion per year in total.²⁸⁰

What is curious is how long the "temperate strategy" has been going on without the Service addressing the issue. Much of the abuse might have been stopped by a simple revenue ruling from the Service outlining a classic case such as the neurosurgeon example and concluding that it does not work; all of the S corporation income is wages. Many practitioners are reluctant to advise clients to violate a revenue ruling. Nor has the Service ever litigated a case similar to the neurosurgeon example, where a meaningful but clearly inadequate salary was paid. That likely would have brought closure to the area. The Service's failure to act has cost the fisc many billions. Of course, the

²⁷⁷ *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

²⁷⁸ I am aware of no hard data on what percentage of the time this use is made of S corporations.

²⁷⁹ See Senate Finance Hearing, *supra* note 264, at 29–30.

²⁸⁰ In 2005, the Treasury Inspector General for Tax Administration estimated that for 2006–2010, unless the law is changed, the Medicare and Social Security tax gap resulting from under-compensation of Subchapter S shareholders-employees would be \$30.2 billion and \$30.8 billion respectively. See *id.* at 51 (prepared statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

repeal of Subchapter S will stop the abuse once and for all.

President Obama, when campaigning for the presidency, proposed expanding the Social Security tax base by having an additional two percent Social Security tax apply to the wages of both employers and employees (four percent of NESE for the self-employed) for those with wages or NESE in excess of \$250,000. There would be no new taxes on the “doughnut” between Social Security maximum (currently \$102,000) and \$250,000.²⁸¹ The loss to the fisc of Medicare and Social Security tax revenues will rise exponentially, if President Obama’s proposal is enacted without addressing the use of S corporations to avoid these taxes.

If it is clear that S corporations can no longer be used to avoid Medicare and Social Security taxes, the political resistance to the repeal of Subchapter S likely will be dramatically lessened. This is particularly true if the legitimate benefits of Subchapter S are incorporated into Subchapter K, and taxpayers are given a taxpayer-friendly way of exiting Subchapter S. I discuss the latter point in more detail below

IV. Popularity of the Various Business Entities

Given the way tax law has developed, one would expect C corporations with their double tax burden to have dropped in popularity, and flow-through entities such as LLCs and S corporations to have increased in popularity. The data and expectations are in alignment. Below is a chart showing the

²⁸¹ See Notice 2007-92, 2007-47 I.R.B. 1036; see also, e.g., Glenn Kessler, *Obama Defines Social Security “Doughnut” Plan*, June 13, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=ahPYltpKKVXA&refer=home>.

relative popularity of C corporations and pass-through entities based on tax returns:²⁸²

Figure 2.—Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2005

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

²⁸² JCX-48-08, *supra* note 5, at 9 (citing Internal Revenue Service, STATISTICS OF INCOME, published and unpublished data).

One would also expect the popularity of LLCs to have grown. As I discussed above, they offer the potential for relative simplicity along with a liability shield.²⁸³ And again, the facts bear this out. This chart shows the relative popularity of LLCs over general and limited partnerships.²⁸⁴

Figure 4.—Domestic Partnership Returns by Type of Partnership, 1989-2005

Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007.

²⁸³ See *supra* text accompanying notes 105–08.

²⁸⁴ JCX-48-08, *supra* note 5, at 11 (citing Bill Pratt, *Partnership Returns, 2000*, SOI BULLETIN, Fall 2002, at 47; Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2005*, SOI BULLETIN, Fall 2007, at 77–78).

The following chart shows the number of partnership tax returns by type.²⁸⁵ LLCs now dominate.

Year	Type of Partnership				
	Domestic General Partnerships (thousands)	Domestic Limited Partnerships (thousands)	Domestic Limited Liability Companies (thousands)	Domestic Limited Liability Partnerships (thousands)	Foreign Partnerships (thousands)
1990	1,267	285	n.a.	n.a.	n.a.
1991	1,245	271	n.a.	n.a.	n.a.
1992	1,214	271	n.a.	n.a.	n.a.
1993	1,176	275	17	n.a.	n.a.
1994	1,163	283	48	n.a.	n.a.
1995	1,167	295	119	n.a.	n.a.
1996	1,116	311	221	n.a.	n.a.
1997	1,069	329	349	n.a.	n.a.
1998	945	343	470	26	n.a.
1999	898	354	589	42	n.a.
2000	872	349	719	53	3
2001	815	369	809	69	5
2002	780	377	946	78	3
2003	757	379	1,092	88	3
2004	725	403	1,270	89	4
2005	729	414	1,465	100	5

n.a.—not available

The final chart shows the number of business entities filing tax returns in 1993, 1998, and 2003, classified by asset size and type of entity.²⁸⁶ Small entities are those with less than \$100,000 in assets, medium sized entities are those with between \$100,000 and \$1 million in assets, and large entities are those with more than \$1 million in assets. Note that C corporation use has dropped in all three classes. This is somewhat surprising in the large class, and may be attributable to the fact that the definition of large is not all that large, \$1 million. If the large entity class started at \$10 million, the results might be different. S corporation and tax partnership use has increased, but S corporations dominated in 1998 and 2003 among small entities and lead in 2003

²⁸⁵JCX-48-08, *supra* note 5, at 12 (citing Bill Pratt, *Partnership Returns, 2000*, SOI BULLETIN, Fall 2002, at 45; Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2003*, SOI BULLETIN, Fall 2005, at 50; Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2005*, SOI BULLETIN, Fall 2007, at 69).

²⁸⁶JCX-48-08, *supra* note 5, at 10.

among medium sized entities.²⁸⁷

Figure 3.—The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003

Source: Joint Committee on Taxation staff tabulations of Statistics of Income, published and unpublished data.

It is commonly said that LLCs are the “entity of choice,” yet, as of 2003, S corporations continue to lead the pack among small and medium sized business entities, though the prior charts show LLCs to also be very popular in 2003. To what is the S corporation popularity attributable? Taxpayers do not explain why they choose a particular entity when they file their tax returns, but the common belief is that S corporations continue to be popular because of the perceived opportunity they provide to reduce Social Security and Medicare taxes. For service businesses, tax partnerships such as LLCs offer fewer advantages. As they are typically businesses without a large amount of capital, property contributions and distributions likely do not play a large role, and section 754 elections—which can adjust partnership asset bases—tend to be less valuable. These are two areas where partnerships have significant advantages.²⁸⁸

²⁸⁷ C corporations were popular among small and medium sized entities in 1998. This likely is attributable to the availability of the medical expense deductions. In a C corporation, medical insurance expenses paid to employees, including shareholder-employees, are deductible from income under section 162(a) and are not income to the employees due to section 106. This benefit was only available to S corporation shareholders who owned two percent or less of the stock of the S corporation. I.R.C. § 1372(a)(2). A comparable benefit is now available to the self-employed, including partners and greater-than-two percent shareholders of S corporations, in section 162(d). It permits them to deduct the cost of medical insurance. See Pub. L. No. 105-206, 112 Stat. 685 (1998); Pub. L. No. 105-277, 112 Stat. 2681 (1998).

²⁸⁸ See *supra* text accompanying notes 66–74, 84–92.

On the other hand, the ability to vary allocations, which can readily be done in a partnership, can be important to a service business. S corporations cannot vary allocations as such, but must allocate income and losses based on shareholdings.²⁸⁹ It is possible to give a shareholder—employee an option to buy more shares, but it is highly awkward to continually adjust share ownership. An S corporation can make bonus salary payments, but that does not avoid the Medicare or Social Security taxes, which applies to all salaries paid, and thus a principal motivation for using S corporations is removed.²⁹⁰ However, the vast majority of S corporations have two or fewer shareholders (over 88% in 2004).²⁹¹ For S corporations with few shareholders, the need to vary allocations is much less than it is, for example, for large and medium-sized law firms, which, not by coincidence, are usually not S corporations.²⁹² Large law firms likely cannot meet the 100 shareholder requirement. Medium-sized law firms that would use the S corporation format likely can only vary incomes, as a practical matter, through bonus salary payments. Again, as salary payments do not avoid Social Security and Medicare taxes, there is little motivation to use the S corporation. That being the case, most medium-sized law firms (as well as most large law firms) are LLCs or LLPs.

Another disadvantage of S corporations when contrasted with partnerships is the inability to include corporate borrowings in the bases of the shareholder's stock.²⁹³ But the need for greater bases is most acute when businesses operate at a loss, not typical of the average service business. Further, the well-informed can arrange for loans to be made directly to shareholders who then can contribute or loan the funds to the S corporation. According to 2005 data, 99% of S corporations have fewer than \$1 million in receipts.²⁹⁴ Shareholder guarantees of debt are likely to be required regardless for firms of this size, so there is no great sacrifice in having the shareholders borrow the funds directly. Further, if the S corporation has only one or two shareholders, some of the problems with such direct borrowings, discussed earlier, are less likely to arise.²⁹⁵ For example, it is easier for one or two shareholders to buy encumbered property and lease it to the corporation than for 20 shareholders to do so.

In a partnership, the partnership can usually give a service provider a profits interest tax free.²⁹⁶ But for a closely held service business, this ability is rarely of great import. It is a very valuable feature in a capital intensive enterprise, where one person provides the funds and another the "brains," but in the

²⁸⁹ I.R.C. §§ 1366(a), 1377(a).

²⁹⁰ I.R.C. §§ 3101(a), 3111(a).

²⁹¹ See SOI TAX STATS, *supra* note 110.

²⁹² Robert W. Hillman, *Organizational Choices of Professional Service Firms: An Empirical Study*, 58 BUS. LAW. 1387, 1401 (2003).

²⁹³ See *supra* text accompanying notes 79–83.

²⁹⁴ JCX-48-08, *supra* note 5, at 15.

²⁹⁵ See *supra* text accompanying notes 79–83.

²⁹⁶ See *supra* text accompanying notes 93–104.

typical closely held, capital-light service partnership, this distinction does not exist. There is relatively little capital involved, and usually everyone is providing services in some form.

As this discussion demonstrates, the main advantages of partnerships are of little value to small, closely held service businesses. When that fact is contrasted with the possible ability to save substantial Medicare taxes and possibly even Social Security taxes with an S corporation, it is no contest, the S corporation wins. Thus, a strong circumstantial case can be made that "Social Security and Medicare tax dodging" is a primary, perhaps *the* primary, force behind the use of S corporations.

While the repeal of Subchapter S will end the abusive avoidance of Social Security and Medicare taxes, it is important not to stop there. It is vital that the rules for assessing Social Security and Medicare taxes be brought into alignment with today's LLC-rich universe.

V. H.R. 4137

It is a happy day for a law professor when a suggestion in a law review article shows up in legislation. I had that good fortune with H.R. 4137, introduced in 2004 by Congressman Amory Houghton, Jr. Alas, that was the extent of my good fortune. H.R. 4137, as it happened, went absolutely nowhere; a pity, really, because it was a forward-looking, if imperfect bill.

H.R. 4137 prohibited further S elections. After a ten-year grace period, it provided that existing S corporations were deemed to elect to be taxed as partnerships under Subchapter K, though the bill also allowed them to elect to make the switch before that.²⁹⁷ Moreover, it permitted most nonpublicly traded C corporations to elect to be taxed under Subchapter K as well.²⁹⁸ Under the bill, when an S corporation elected Subchapter K, it was treated as if it liquidated and formed a partnership. Thus, as noted above, the S corporation recognized the gain and could recognize the loss inherent in its assets;²⁹⁹ that gain or loss, like any S corporation gain or loss, flowed through to the shareholders under section 1366. To make the gain and loss recognition more palatable, the bill provided that the gain and loss recognized by the S corporation was amortized over five years, which lessened the pain if there was a gain and caused pain if there was a loss. There was nothing in the bill, however, to stop an S corporation from actually liquidating and forming, for

²⁹⁷ H.R. 4137 does not take disregarded entities into account. H.R. 4137, *supra* note 4.

²⁹⁸ Corporations ineligible to elect under Subchapter S are not allowed to elect subchapter K. See I.R.C. § 1361(b)(2). Included in this group are financial institutions which use the reserve method of accounting for bad debts described in section 585 (*e.g.* many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations.

²⁹⁹ Code section 336 provides that gain is recognized on the liquidating distribution of appreciated property but limits loss recognition if the liquidating distribution is to a related person. See I.R.C. § 336(a), (d).

example, an LLC. That approach permits a loss (or a gain) to be recognized fully and immediately.³⁰⁰

Under the bill, any distribution from the erstwhile S or C corporation—now—partnership to its shareholders—now—partners was a taxable dividend to the extent it would have been a dividend under the rules of Subchapter S.³⁰¹ As discussed above, dividends are paid from a corporation's earnings and profits.³⁰² As also discussed above, an S corporation cannot generate earnings and profits, but it can inherit them from a C corporation; a distribution from an S corporation is a taxable dividend to the shareholders if, to simplify, the S corporation has already distributed its own net income, but has earnings and profits.³⁰³ Under the bill, an S corporation's or C corporation's earnings and profits were passed on to the partnership. H.R. 4137 provided a rule for the S corporation—now—partnership or C corporation—now—partnership that was similar to the rule that currently exists for S corporations. If, again to simplify, the partnership had fully distributed its own post-conversion net income,³⁰⁴ any additional distributions were taxable dividends to the partners to the extent of the partnership's earnings and profits. This, of course, was an effort by the bill to retain the double taxation that would have applied to the C corporation if it had never elected to be taxed as a partnership (or never elected Subchapter S on its way to being a partnership). Note, though, that the partnership would have had control over the timing by choosing or not choosing to make the distribution. Keeping track of the earnings and profits over time poses a significant burden. Under the H.R. 4137, earnings and profits never expired.

Under H.R. 4137, it often would have made more sense for an S corporation with earnings and profits to actually liquidate and form another entity than to simply elect (or be deemed to elect) Subchapter K. As discussed above, the S corporation that did not actually liquidate was still deemed to liquidate and was still required to recognize the gains and losses inherent its assets. The main tax advantage under the bill to electing K as opposed to actually liquidating was that the recognized gains were taken into account over five years. But in the case of an actual liquidation, the earnings and profits account is wiped clean.³⁰⁵ No earnings and profits means no dividends. Had H.R. 4137 been enacted, S corporations with earnings and profits and net gains in their assets would have needed to balance the deferral of tax gain against the ability to avoid dividends. Of course, if the S corporation had both net losses in its assets and earnings and profits (less common, but entirely possible), there

³⁰⁰ Subject to section 336(d).

³⁰¹ See *supra* text accompanying notes 47–50.

³⁰² See *supra* text accompanying notes 21–22.

³⁰³ See *supra* text accompanying notes 47–50.

³⁰⁴ Any S corporation net income retained upon the conversion is added to this amount.

³⁰⁵ The authority for this is implicit in the operation of sections 334(a) and 336 and the fact that no provision of the code provides otherwise. See BITTKER & EUSTICE, *supra* note 10, § 10.05[2][b].

would have been nothing to balance. Liquidation would have been the order of the day.

H.R. 4137 also expanded the scope of section 1374. Under the bill, upon the election to be taxed as a partnership, a C corporation, unlike an S corporation, did not recognize any gains or losses inherent in its assets.³⁰⁶ Instead, section 1374 was applied to the C corporation-now-partnership.³⁰⁷ Recall, that as enacted section 1374 applies to an S corporation if it was once a C corporation or acquired the assets of a C corporation in a tax-favored transaction.³⁰⁸ When the S corporation recognizes a gain inherent in an erstwhile C corporation asset, whether by sale or distribution to a shareholder, a corporate level tax applies, and it applies at the highest corporate tax rate.³⁰⁹ The objective of section 1374 is to ensure that the net gain inherent in the assets originally held by the C corporation is subject to a corporate level tax, notwithstanding the fact that the assets are held by an S corporation.

How H.R. 4137 applied section 1374 to the C corporation-now-partnership is not entirely clear. The idea, clearly, was that there be two levels of tax on the net gains inherent in the erstwhile C corporation assets, one at the entity (*i.e.* partnership) level at the highest corporate tax rate, and one at the partner level. Further, the time period during which section 1374 applied was expanded from the ten years that normally applies to 25 years.³¹⁰ The section 1374 provision of the bill was, in the main, unworkable. Section 1374 works in the S corporation context because gains and losses normally are recognized if an asset leaves corporate solution.³¹¹ But that is not necessarily true for partnerships. Under section 731(b), a partnership normally recognizes no gain or loss when it distributes property to partners. The distributee partners generally take a carryover basis in the distributed property.³¹² The equivalent of an animal tagging rule could have been added to H.R. 4137, providing that whoever disposes of a covered asset within the 25 year time period in a taxable transaction must pay the corporate tax, but that would have been exceptionally difficult to enforce, especially over 25 years. Alternatively, the Subchapter K rules could have been changed to require gain recognition any time a covered asset is distributed, but again that would have been difficult to enforce, especially over 25 years, plus does injury to one of the more fundamental rules of partnership taxation. Also, it is not apparent why the ten year

³⁰⁶ H.R. 4137, *supra* note 4.

³⁰⁷ *Id.*

³⁰⁸ See *supra* text accompanying notes 51–55.

³⁰⁹ See I.R.C. § 1374.

³¹⁰ H.R. 4137 is not clear in this regard, but apparently an electing S corporation does not recognize the gains or losses in assets subject to section 1374 before the conversion to a partnership. Section 1374 continues to apply as it would to an electing C corporation. See *supra* text accompanying notes 51–52. Further, if section 1374 already applies, the ten-year rule (and not the 25 year rule) applies, provided the ten years expires before the election is made to be a partnership.

³¹¹ This is normally a taxable event. See I.R.C. §§ 311, 336.

³¹² See I.R.C. § 732(a).

time frame of current section 1374 was increased to 25 years. The extension creates a huge, additional compliance burden, and ten years is a time limit the world has been living with comfortably since section 1374 was enacted.

Clearly, Congressman Houghton was attempting to permit the laudable, allowing C corporations to elect Subchapter K, while avoiding the objectionable, permitting large amounts of C corporation gain to avoid a corporate level tax. He doubtless also wanted to avoid excessive revenue losses to the fisc. I will return to this issue when addressing my own proposal, but applying section 1374 in the manner H.R. 4137 did was at best an awkward solution.

Finally, H.R. 4137 made useful, if insufficient, steps in related areas. It specifically allowed a section 351 incorporation followed by a section 368 reorganization, provided that substantially all of the assets of an active trade or business were involved.³¹³ It also contained a provision on section 1402 that was close to the AICPA's proposal.³¹⁴ The intent behind both provisions was good, but for the reasons I discussed in detail above, I recommend a different approach.³¹⁵

VI. Repeal Subchapter K Instead?

Much ink has been spilled on the problems with Subchapter K.³¹⁶ It is surely true that abuses can happen. While it does not usually make the life of a Mom and Pop LLC all that challenging, Subchapter K and its regulations are an extraordinarily complex area of tax law. Of just one piece of this puzzle, the special allocation rules of section 704(b), Professor Lawrence Lokken famously wrote: "[They are] a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."³¹⁷ Professors George Yin and David Shakow, as Reporters for the American Law Institute, produced an impressive study that was critical of Subchapter K. In it they proposed "an optimal tax system" for the "simple private business firm" grounded in

³¹³H.R. 4137, *supra* note 4.

³¹⁴See *supra* text accompanying notes 244–48.

³¹⁵See *supra* text accompanying notes 264–67.

³¹⁶See, e.g., William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105 (1991); Noel B. Cunningham, *Commentary, Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 109 (1998); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980); Philip F. Postelwaite et al., *A Critique of the ALI's Federal Income Tax Project-Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993); see also Karen Burke, *Partnership Distributions: Options for Reform*, 3 FL. TAX REV. 677 (1998); Darryll Jones, *Toward Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047 (2006).

³¹⁷Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 621 (1986).

Subchapter K, but "with a strong resemblance to Subchapter S."³¹⁸ Professors Yin and Shakow did not launch a full frontal assault on Subchapter K, perhaps cognizant of the political perils of such an effort. In addition to the private business firm proposal, they did recommend a number of substantial changes to Subchapter K, however.³¹⁹

I actually think that Subchapter K has much to commend it. The flexibility it offers promotes economic efficiency. Yes, abuses can happen, but I have yet to see any data suggesting that they are a large part of the partnership pie. Further, S corporations, with their rigid qualification rules, particularly the one class of stock requirement, are simply unsuitable for many complex business undertakings where income is often allocated in tranches to different owners. But happily, I do not need to engage that debate here. The reality is that repealing or dramatically changing Subchapter K is a political nonstarter. Perhaps the best evidence of that fact is that Professors Yin and Shakow were not able to persuade the American Law Institute, a reform-oriented and—in the view of some, moderately progressive—organization, to adopt their views, notwithstanding that they did not even go so far as to recommend repeal of Subchapter K. Repeal of Subchapter K has never been given serious consideration by Congress. In contrast, there has actually been a bill in the House recommending repeal of Subchapter S.³²⁰ Further, some kind of partnership taxation will always have to be with us if for no other reason than taxpayers can inadvertently find themselves in a state law partnership.³²¹ They cannot inadvertently end up in an S corporation. So, if we cannot repeal Subchapter K, surely we should repeal Subchapter S. As the above discussion indicates, the legitimate benefits of Subchapter S are relatively few in number and can either be incorporated into Subchapter K or be achieved by some adjustments to Subchapter C. Having two pass-through regimes is inefficient. Similarly situated taxpayers are taxed differently, to the advantage of those with skilled advisors, often to the disadvantage of those with unskilled advisors. This violates principles of vertical equity. Well-advised taxpayers can effectively choose, albeit within limits, how much tax to pay. Taxpayers will exploit the differences between their regimes for their benefit. A classic example is using S corporations to beat the Medicare tax. These considerations make it more difficult for the government to assess a reliable, appropriate tax.³²² Further, the

³¹⁸ See ALI Report, *supra* note 91, at 125. This would have been an elective system. For example, it would have in some cases severely restricted special allocations and would have required gain recognition (as well as loss recognition in the case of a liquidation) on the distribution of assets. See also *id.* at 129–30 (Table 1); *id.* at 183 (Proposal 4-2(1)(a)); *id.* at 215 (Proposal 4-5(1)(a)); *id.* at 300 (Proposal 5-1(1)(a)); Jeffery A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000).

³¹⁹ See generally ALI Report, *supra* note 91, at 273–425.

³²⁰ H.R. 4137, *supra* note 4; see *supra* text accompanying notes 297–315.

³²¹ See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIPS § 2.01(c) (1988).

³²² See ALI Report, *supra* note 91, at 45–47.

Service is required to train personnel in two different pass-through regimes.

That said, Subchapter K is a far from perfect taxing regimen. The ALI Report and others have pointed out its deficiencies and made intelligent recommendations for improvement. Reform of Subchapter K should continue. But the fact that Subchapter K is in need of reform is not a reason to continue a parallel pass-through regime in Subchapter S. One of the two systems needs to go. It won't be Subchapter K; therefore it should be Subchapter S. Indeed, the existence of Subchapter S impedes the reform of Subchapter K. Having two systems in play can prevent policy makers and the Service from becoming fully focused on one. It spreads limited human resources thin. Likely, the pace of reform of Subchapter K will pick up, once Subchapter S is off the playing field.

VII. Let Nonpublic Corporations Come to the Party

In my prior article, I discussed the possibility of also permitting nonpublicly traded C corporations to elect Subchapter K. At that time, I demurred. I felt repealing Subchapter S was a daring enough move. While I was (and am) aware of no data on the cost to the fisc of allowing only nonpublic C corporations to elect Subchapter K, there was data on the cost of integration for public and nonpublic corporations in the aggregate, and that number was intimidating: \$36.8 billion in 1991 dollars.³²³ As I discuss below, the cost of permitting nonpublic C corporations to elect Subchapter K may now not be large.³²⁴ Further, we live in a different tax and nontax universe than when I wrote my prior article. Somewhat emboldened by H.R. 4137, I believe the time is ripe to permit domestic, nonpublic C corporations to elect Subchapter K as well (or become disregarded entities if they have a single shareholder).³²⁵ Like H.R. 4137, I would exclude corporations that are currently ineligible for Subchapter S from making this election.³²⁶

C corporations can have highly complex stock and debt structures. In many cases, those structures may make the switch to Subchapter K impractical. But usually, Subchapter K will be up to the challenge. Many partnerships

³²³Various integration proposals were considered. The one referenced in the text involves an allocation to shareholders of a 31% credit for corporate taxes paid. Tax-exempt and foreign shareholders would receive no credit. The credit would accompany an allocation of income to the shareholder. DEPARTMENT OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 152 (1992).

³²⁴See *infra* text accompanying notes 358–363.

³²⁵As did H.R. 4137, I define a nonpublic C corporation as a domestic corporation no stock of which is readily tradable on an established securities market or otherwise.

³²⁶Generally, a pass-through regime is highly awkward for these types of entities. Section 1361(b)(2) lists corporations that are ineligible to elect to be taxed under Subchapter S. Included are financial institutions which use the reserve method of accounting for bad debts described in section 585 (e.g. many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations. See I.R.C. § 1361(b)(2); see also EUSTICE & KUNTZ, *supra* note 59, ¶ 3.05.

have highly complex ownership and debt structures, but thrive in Subchapter K.³²⁷

The Federal government is regularly changing the ground under the business owners' feet. An owner who 15 years ago rationally chose a C corporation, might not have done so if she had known of the impending LLC revolution. The tax benefits that she may have gleaned by using a C corporation are, given the overall double tax burden, unlikely to have been so great as to justify locking her into a now outdated choice. Further, why should different nonpublic business entities be taxed differently? Closely held businesses should at least have the option of playing on the same field, making for greater horizontal equity. Other countries have taken a uniform approach.³²⁸ I recommend that the United States also take a more uniform approach, though I would not make the election of Subchapter K mandatory for C corporations. As I discussed above, it would be very difficult for nonpublic entities to get by wholly without Subchapter C.³²⁹ As I discuss below, I recommend that C corporations be allowed to switch to Subchapter K on a taxpayer-friendly basis.³³⁰

VIII. The Nuts and Bolts

A. S Corporations

A first step toward repeal is to prohibit any further S elections, as of the effective date of any relevant act. Here I follow the lead of H.R. 4137.³³¹ No new corporations and no existing C corporations may make S elections. There is no need to create more of a dying entity. There is little unfairness at work here for potential future users, as the LLC usually constitutes a perfectly viable, indeed usually preferable, alternative, especially if the integration proposals I outlined above are adopted.

How should taxpayers who are already operating as S corporations be treated? They cannot be expected to adapt to new rules overnight. But there is also little logic in allowing the indefinite continuation of a dying entity. The sensible answer is to give existing S corporations a meaningful amount of time to exit gracefully. How much time is enough time? There is no certain

³²⁷ See, e.g., Karen T. Lohnes, John Schmalz & Craig Gerson, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-ups, and Waterfalls*, 105 J. TAX'N 109 (2006).

³²⁸ Germany, for example; see Michael J. Munkert, *Fallstricke der neuen Thesaurierungs-begünstigung*, STEUERCONSULTANT 34 (2007).

³²⁹ See *supra* text accompanying notes 113–67.

³³⁰ One might think that permitting C corporations to continue to elect Subchapter S during the ten-year death watch might be a way of facilitating the transition to Subchapter K, but in fact that often, perhaps usually, will not be the case. The S corporation one-class-of-stock rule of section 1361(b)(1)(D) will make Subchapter S unavailable to many existing C corporations. Also, section 1374 will take away much of any tax benefit that Subchapter S provides. See *infra* text accompanying notes 358–64.

³³¹ See S Corp. Burial, *supra* note 3, at 643.

answer, but the ten-year time period of H.R. 4137 seems reasonable.³³²

During the ten-year death watch, an S corporation may:

1. Elect disregarded entity status, if it has a single owner (and be deemed to liquidate and distribute its assets to the single owner),
2. elect Subchapter K, it has two or more owners (and be deemed to liquidate and form a partnership),
3. elect Subchapter C (no liquidation),
4. formally liquidate by the end of the ten-year term, or
5. take no action, in which case at the end of the ten-year term it is deemed to liquidate and form a partnership or, if it has a single owner, it is deemed to liquidate and become a disregarded entity.

If the S corporation does not actually liquidate (and does not elect Subchapter C), it needs to be deemed to be liquidated for tax purposes (1) to establish capital accounts for the partners correctly,³³³ (2) for section 704(c), sections 707(a)(2)(B), and 737³³⁴ to apply properly in the case of partnerships, and (3) to establish the owner's bases in the assets properly if the S corporation becomes a disregarded entity. The regular S corporation rules apply until the liquidation, deemed or actual, takes place, with one modification. I apply my recommended reform of Social Security and Medicare taxes to S corporations during the transition period. Thus, all income of an S corporation primarily engaged in the performance of services is subject to Social Security and Medicare taxes. For capital intensive S corporations, on the other hand, reasonable compensation for services rendered must be paid, but only that compensation is subject to Social Security and Medicare taxes.³³⁵

What tax rules should apply to a deemed or actual liquidation? Under the current rules of Subchapter S, the liquidating S corporation must generally recognize any gain or loss inherent in its assets.³³⁶ That gain or loss, of course, generally is not taxed to the corporation but is passed through to the shareholders.³³⁷ The shareholders recognize a gain or loss based on the difference between the fair market value of the assets received and the basis of the stock they hold.³³⁸ It seems inappropriate, however, to apply the current S corporation rules and require gain (or permit loss) recognition on the termination of

³³²In my prior article I suggested five years. Foolish consistency is the hobgoblin of small minds. See *S Corp. Burial*, *supra* note 3, at 644.

³³³See Reg. § 1.704-1(b)(2)(ii), -1(b)(1)(iv).

³³⁴See *supra* text accompanying note 74.

³³⁵See *supra* notes 264–67. Perhaps the easiest way to accomplish this is to bring S corporations under the self-employment rules, as opposed to continuing their current coverage under sections 3101, 3111, and related provisions. See JCX-48-08, *supra* note 5, at 68; H.R. 3970, *supra* note 272.

³³⁶I.R.C. § 336(a); see *supra* text accompanying notes 39–40.

³³⁷I.R.C. § 1366.

³³⁸I.R.C. § 331(a). The gain or loss to the shareholders may not be significant given the flow-through of the S corporation's liquidation gains and losses, which adjusts the shareholders' bases before the distribution is made to them. Reg. § 1.1367-1(f).

S corporation status.³³⁹ The taxpayers are being forced to use another entity, making gain recognition unfair. Typically, no real disposition is being made. Most owners will continue the same business.³⁴⁰ This makes loss recognition inappropriate. I therefore recommend that S corporations and their shareholders be allowed to move to partnerships or disregarded entities on a tax favored basis. I apply Subchapter K, and not Subchapter S, to the liquidation of S corporations both in the case of partnerships-to-be and (notwithstanding the metaphysical challenges) disregarded entities-to-be. I also, of course, apply Subchapter K to the formation of any subsequent partnership. Subchapter K generally makes the liquidation and formation process tax free. Where a partnership is formed, the typical result of this process is that the erstwhile shareholder's basis in his stock becomes his basis in what is now a partnership interest.³⁴¹ Note that this process gives each partner a capital account in the partnership equal to the partnership interest's fair market value, and the partnership "book bases" in the partnership assets also equal to their fair market value.³⁴² Where the S corporation becomes a disregarded entity, applying Subchapter K-like rules will usually give the single owner a carryover basis in the assets of the S corporation.³⁴³ While the liquidation rules of Subchapter K are much more taxpayer friendly than those of Subchapter S, it is possible for gain or loss to be recognized under Subchapter K on a liquidation in limited circumstances. The liquidation rules are unlikely to apply, however, especially if the assets are distributed (or deemed distributed) to the owners in proportional, undivided interests.³⁴⁴ I considered rules that would avoid the recognition of all gain or loss in all circumstances, but found that the complexities these rules generated were not worth the statutory effort given that the issue should be a minimal one.

Sufficiently creative taxpayers can find ways of inappropriately taking advantage of these generous rules for liquidation of S corporations. To stop, or at least impede, this, I recommend Congress authorize the Service to adopt

³³⁹ See I.R.C. §§ 331(a), 336(a).

³⁴⁰ They may want to actually liquidate the S corporation and form, for example, an LLC. Or they may want to continue using the state law corporation, which either is disregarded for tax purposes if it has a single owner, or is taxed under Subchapter K if it has multiple owners.

³⁴¹ See I.R.C. §§ 731(a), 721(a), 732.

³⁴² See Reg. § 1.704-1(b)(2)(ii), -1(b)(1)(iv). This sentence is probably Greek to those without a partnership tax background. Explaining it here would require a multiple-page footnote. For those wishing to develop that background, see WILLIS, et al., *supra* note 153, § 10.04[3][c].

³⁴³ See I.R.C. §§ 721(a), 731(a), 732.

³⁴⁴ Gain will be recognized if money is distributed in excess of the erstwhile shareholder's basis in her stock. Loss will be recognized if only money, inventory, and accounts receivable are distributed, and the owner's outside stock basis exceeds the carryover basis she takes in these assets. See I.R.C. §§ 731(a), 732. One might ask if an artificial loss could be created, for example, by distributing money, inventory, and accounts receivable to a partner in such a way that a loss is generated, notwithstanding the fact that on a fair market value basis the partner has an economic gain section 751(b) usually will kibosh that effort, however.

an anti-abuse rule that applies to this process.³⁴⁵

Note that under my proposal, S corporations do not have the option of liquidating under the current S corporation rules. This is to prevent taxpayers from cherry-picking tax treatment, that is, using Subchapter S for S corporations with net losses in their assets and Subchapter K for S corporations with net gains. It is appropriate, however, to have a brief transition period of perhaps six months where S corporations are allowed to liquidate under either Subchapter K or S. Taxpayers planning to liquidate anyway should not be caught unawares by the statutory change. While cherry-picking can happen during the six months, the associated revenue losses are not likely to be great given the limited time frame. Further, S corporation losses and deductions, including depreciation deductions, generally flow through to the shareholders.³⁴⁶ In other words, the losses have often already been recognized by the shareholders. As a consequence, it is not likely that there are a large number of S corporations with large amounts of losses inherent in their assets, though there will be some with economic losses that have not yet been taken into account for tax purposes.³⁴⁷

While it is difficult to predict with certainty in the absence of hard data, it seems doubtful that permitting largely tax-free liquidations of S corporations will generate unacceptable revenue losses for the fisc. Under the current rules, S corporations avoid distributing assets that contain significant amounts of appreciation. Instead, they commonly retain the property in corporate solution, depriving the government of a recognition event. In addition, Social Security and Medicare tax revenues will no longer be lost, creating a substantial offset. If economic calculations reveal that the cost to the fisc is unduly large, some compromise with the suggested approach may have to be found.

What if the S corporation has earnings and profits or unrecognized section 1374 gains?³⁴⁸ The equities in this regard are not as strong as the equities in favor of allowing nonrecognition of the (nonsection 1374) gains and losses inherent in the S corporation assets. The earnings and profits and section 1374 gains originated with a C corporation, and avoiding any tax consequence also avoids what would have been part of the Subchapter C double tax system, and Subchapter C is not being recommended for repeal. That said, if a C corporation liquidates under the current rules, it recognizes the

³⁴⁵One example: A and B own all of the stock of an S corporation. A individually owns asset X and B individually owns asset Y. They wish to exchange these assets with each other. The assets do not qualify for like-kind exchange treatment under section 1031. To avoid gain recognition, they could each contribute the assets to the S corporation. The contribution would be tax free under section 351(a). As part of a subsequent liquidation of the S corporation under Subchapter K, the S corporation could distribute asset Y to A and asset X to B, potentially tax free. See I.R.C. § 731.

³⁴⁶I.R.C. § 1366.

³⁴⁷A drop in the value of land, for example, would normally only be recognized in the case of taxable disposition, as land is not depreciable.

³⁴⁸See *supra* text accompanying notes 47–55.

gains and possibly the losses inherent in its assets, but its earnings and profits account is wiped clean.³⁴⁹ Further, the section 1374 gains are only recognized for ten years after the C corporation assets find their way into an S corporation.³⁵⁰ Since under my proposal, the S corporation has up to ten years to liquidate, section 1374 by its own terms normally can be avoided by waiting until the end of the section 1374 ten-year term, which will be reached before the end of the ten-year S corporation liquidation term of my proposal.³⁵¹ If the S corporation chooses to liquidate before the end of the section 1374 ten-year term, it is presumably due to some tax or other advantage. Having section 1374 fully apply in these circumstances is not unfair. Accordingly, on liquidation of the S corporation, any remaining section 1374 gains are recognized, but there should be no dividend effect. Below, I raise the possibility of C corporations being allowed to elect to liquidate under Subchapter K. If that is permitted, it would of course not make sense to apply section 1374 to liquidating S corporations.

A danger, though not an especially large one, is that C corporations, anticipating the law change, might elect Subchapter S shortly before the new statute is enacted. Under my proposal, they cannot elect after enactment. The C-now-S corporation could wait out the ten-year section 1374 period and then liquidate, generally tax free, under Subchapter K. But the C corporation must live with Subchapter S and section 1374 for ten years. It is not much differently positioned than a C corporation that legitimately elects Subchapter S, say, one year before the enactment of the new statute. While there is some minor potential for game playing here, I do not believe it is worth addressing statutorily. Of course, if C corporations are permitted to exist under the rules of Subchapter K, discussed below, then there is no abuse potential.

Should the proposed act contain continuity of business enterprise and ownership interest tests? Should the business of the erstwhile S corporation be required to be continued for some period of time? Should the erstwhile shareholders be required to stay on as partners for some period of time?³⁵² While the failure to apply those tests may mean that some owners will be able to convert corporate assets to personal use without an income tax effect,³⁵³ on the whole, the better answer to the question is not to apply continuity of interest standards. Because S corporations are being forced out of existence,

³⁴⁹ See *supra* text accompanying notes 25–26, 305.

³⁵⁰ I.R.C. § 1374(d)(7).

³⁵¹ Since no new S elections are permitted, the last possible S election would take place the day before the act takes effect, meaning the section 1374 ten-year term expires the day before the proposed statute's ten-year term.

³⁵² These rules apply to corporate reorganizations. See BITTKER & EUSTICE, *supra* note 10, §§ 12.21, 12.61[2].

³⁵³ This could not happen with an S corporation, since the distribution of property by an S corporation to its shareholders causes gain and possibly loss to be recognized under sections 311(b) and 336. On the other hand, a distribution of property by a partnership to a partner is generally not recognized to either party. See I.R.C. § 731; *but see* I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 737, 751(b).

the equities favor an owner-friendly set of rules. Also, aside from the possibility of converting business assets to personal use, which will likely be uncommon, the relevant tax consequences after the conversion are similar to, or even worse than, those before the conversion. Some examples: A sale of stock in the S corporation usually generates a capital gain or loss. The sale of a partnership interest may generate ordinary income.³⁵⁴ The gain or loss on the sale of business assets generally flows through to the shareholders for S corporations and to partners for partnerships. Also, determining whether the continuity tests are met will create additional complexity that does not seem worth the statutory effort. Numerous questions will arise. How long should the business be operated? What if the assets are used in a different business? How much of an ownership change is permitted? Many of these issues have been addressed in the corporate context. But in the case of S corporations being forced out of existence, the courts might address these issues differently.³⁵⁵ Further, if continuity provisions are enacted, most owners likely will continue the business long enough to pass muster, so little revenue will be raised.

The conversion of S corporations can generate state tax and nontax costs, if the corporation actually liquidates and contributes its assets to, for example, an LLC. State income and, more commonly, transfer taxes can apply. These vary a great deal from jurisdiction to jurisdiction. In some cases they will pose a significant limitation, in others not. Transfer taxes often apply principally to real estate. Partnerships, rather than S corporations, have always been the preferred vehicle in which to hold real estate.³⁵⁶ Accordingly, transfer taxes may pose less of a burden than appears at first blush. One also hopes that states will follow the Congressional lead, and permit S corporations to liquidate without a significant tax impact. As discussed above, states can assist this process by permitting direct entity conversions of corporations into LLCs, thereby avoiding transfer tax and transfer restriction problems that might otherwise arise.³⁵⁷

B. C Corporations

For newly formed C corporations electing to be taxed under Subchapter K, rules will need to be developed that track the section 704(b) allocation rules with the multiple classes of stock possible in a C corporation. Other special issues may arise, but they should be manageable. A separate question arises for existing nonpublic C corporations wishing to elect Subchapter K, (or disregarded entity status). How should they get from here to there? It does not seem equitable for them or their owners to pay a substantial tax penalty to get into the entity of choice of the day, a choice that may not even have

³⁵⁴ See I.R.C. § 751(a).

³⁵⁵ See BITTKER & EUSTICE, *supra* note 10, §§ 12.21, 12.61[2].

³⁵⁶ An exception is when the capital gain freeze technique is used. See *supra* text accompanying notes 192–202.

³⁵⁷ See *supra* text accompanying notes 183–85.

been available at the time they were formed. Therefore, if it does not break the back of the fisc, I recommend that qualifying, existing C corporations also be allowed to follow the same procedures as described above for S corporations, that is, during the ten-year window, to liquidate under Subchapter K. As Subchapter C is continuing, I do not make this approach mandatory as I do for S corporations. It would be almost impossible to keep track of C corporations liquidating for independent reasons and those liquidating to continue under Subchapter K. Thus, C corporations have the option of liquidating under the current rules, which they will prefer if overall it generates losses.³⁵⁸

As noted above, under the current rules, gain and possibly loss is recognized on an actual liquidation, but the earnings and profits account is normally wiped clean.³⁵⁹ Thus, what the fisc is giving up under my proposal is not the tax on dividend income, which in the case of a liquidation it will not collect, but the tax on the net gains inherent in the assets of some nonpublicly traded C corporations. I say some, because many corporations will not sell or distribute many of those assets if it means paying a tax. Further, for domestic transactions, at least, C corporations are not a popular vehicle for nonpublic businesses. LLCs have become the entity of choice.³⁶⁰ It will be important for the number crunchers to crunch the numbers, but the cost to the fisc may not be that high.

Some will view my proposal as an unduly liberal giveaway. And indeed, as I discuss below, its cost may be too high. But there are also economic inefficiencies that are created when some taxpayers are forced to operate within an outdated form and others are not. New businesses forming LLCs have a competitive advantage over older businesses trapped in C corporations. Electing S corporation status may not be available if their ownership structure does not permit a single class of stock. Leveling the playing field should make for a more efficient economy.

If the costs to the fisc of my proposal for existing C corporations are too high, a simple solution, and probably as reasonable as any, is simply to leave the current rules for liquidating C corporations in effect with one adjustment. That is to say, existing nonpublic C corporations may, during the ten-year window, elect Subchapter K or disregarded entity status, but if they do so they are deemed to liquidate under Subchapter C, recognizing the gains and possibly the losses per its rules.³⁶¹ The adjustment: To limit the tax pain, I propose that the taxes owed be payable over five years.

Whichever of these rules are used for existing C corporations, they should only apply during the ten-year window. To allow these tax benefits for C corporations that liquidate after the ten-year window is to permit them to have

³⁵⁸It is not out of the question that they will prefer it in a gain situation, as it means a basis step up.

³⁵⁹I.R.C. § 336; BITTKER & EUSTICE, *supra* note 10, § 10.05[2][b]. See *supra* text accompanying note 305.

³⁶⁰See *supra* text accompanying notes 19–35, 67–108.

³⁶¹See *supra* text accompanying notes 24–25.

their cake and eat it to, using Subchapter C when it is beneficial and switching to Subchapter K when it is not, indefinitely.

Assuming a favorable environment in which qualifying C corporations can elect Subchapter K at a low tax cost, will the LLC revolution be reversed or at least slowed? Rather than forming LLCs, will taxpayers form corporations and elect Subchapter K? While this is not necessarily a bad thing, it is not a likelihood for nontax reasons. State LLC statutes have more modern, flexible statutory architectures in comparison to typical corporate statutes.³⁶² Indeed, many who prefer for whatever reason to operate in C corporations for tax purposes often form LLCs and then check the box to be taxed as C corporations to take advantage of the greater state law flexibility LLCs offers.³⁶³ Further, it is safer to be in an LLC if Congress changes its mind. Congress is more likely to change the way state law corporations are taxed than the way LLCs are taxed, given the history of each.

Conversely, would it make sense to *only* allow the use of C corporations for corporations that are publicly held or are about to go public? My recommendations are an attempt to put all businesses on the same playing field, but some could opt to use or stay with C corporations. Should that option be available? Generally, the answer is yes. C corporations are too woven into the economic fabric to not allow people to use them. For example, as noted earlier, C corporations are often preferred for outbound foreign transactions because of the preferential tax rates many treaties give dividends, and preferred for inbound transactions due to the imperfections with the branch profits tax.³⁶⁴ But, C corporations are reported to often be used for an extra run up the rate brackets, and that likely will become a more common reason for using C corporations in a tax universe where LLCs are otherwise usually the more logical choice.³⁶⁵ At the same time, taxpayers making legitimate use of C corporations should not have a radically different tax structure than individuals. As a compromise position, and to help offset possible revenue losses from my proposals, I recommend that the 15% corporate bracket of section 11 be eliminated, and thus that the tax rate on the first \$75,000 of income be 25%.

C. *The States*

I have already discussed the need for states to cooperate with this process. A related question is whether states will use the new single tax burden on (at least most) closely held business entities as an opportunity to increase their own taxes. That is to some extent already going on. An increasing number of

³⁶² See BISHOP & KLEINBERGER, *supra* note 17, § 1.02.

³⁶³ LLCs can also elect to be taxed as S corporations. See I.R.S. Form 2553.

³⁶⁴ See *supra* text accompanying notes 28–30.

³⁶⁵ See *supra* text accompanying notes 30–32.

states are taxing LLCs at the entity level.³⁶⁶ While this trend may continue, it does not provide a reason for the federal government not to establish a more rational tax system. The 50 states and the District of Columbia compete with one another. Let that competition and their voters determine their tax systems.

XIX. Conclusion

The repeal of Subchapter S is justified both on grounds of tax efficiency and political realism. The country does not need two pass-through business entity tax regimes, and only the repeal of Subchapter S is politically realistic. A few relatively modest Code changes permit the important, defensible benefits of Subchapter S to be retained. The repeal of Subchapter S allows the Service to make better use of its personnel. It also makes for readier reform of Subchapter K. The Treasury and Congress, their attention no longer divided between two tax systems, and their limited human resources no longer spread as thin, can bring greater focus to that task. Finally, the time has come to allow nonpublic C corporations to elect Subchapter K as well, ideally on a taxpayer-friendly basis. Shareholders should not be trapped with an antiquated choice.

³⁶⁶ See Bruce P. Ely, Christopher R. Grissom, & Matthew S. Houser, *Charts Comparing the State Tax Treatment of LLCs and LLPs*, in LIMITED LIABILITY COMPANY HANDBOOK § 3:118 (Mark Sargent & Walter Schwidetzky eds., 2008).