May 15, 2013

Testimony Before the Subcommittee on Select Revenue Measures of the Ways and Means Committee on the Discussion Draft Provisions To Reform the Taxation of Small Businesses and Passthough Entities

Good morning.

My name is Willard Taylor. I am an Adjunct Professor at New York University Law School and also teach at the Yale and University of San Diego Law Schools – in each case, a course on the Federal income taxation of business passthroughs. I am grateful the opportunity to testify on this subject today.

The Ways and Means Committee discussion draft on the reform of the taxation of passthrough entities, released in March, includes two options for structural change, one consisting of specific changes to the Subchapter S and partnership rules and the other, option 2, consisting of a fundamental revision of Subchapter S and of the partnership rules, resulting in a single set of rules for all non-publicly traded passthrough entities.[1]

The changes proposed in option 1 are, in my view, good – others could (and should) be added[2] and some of the issues could be addressed differently,[3] but the

[1] The draft also includes items specifically directed at small business, such as the expensing of certain expenditures and the use of cash method accounting, and changes to the dues dates for business tax returns.

[2] Such as the repeal or modification of the technical termination rule in Section 708(b)(1); a more inclusive definition of "investment company" definition in Section 721(b); and the treatment of interests in a publicly-traded partnership as "securities" for purposes of Section 1058. With respect to the need for a more inclusive definition of a Section 721(b) investment company, *see* Report No. 1252 of the NYSBA Tax Section, Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F) (December 28, 2011) at pages 1 (text at note 1) and 11-12.

[3] For example, the Administration's fiscal 2014 revenue proposals would change Sections 743(d), relating to built-in losses, and 704(d), relating to the basis limitation on losses, but in a different way than the changes in option 1. *See* Department of the Treasury, General

changes proposed by option 1 have been around for some time[4] and make sense. The option 1 changes, however, are "improvements," not basic tax reform, and so I feel strongly that Congress should focus on the option 2 proposal to have a single set of Federal income tax rules for all non-publicly traded passthroughs.

Why does it make sense to have a single set of rules for all non-publicly traded passthroughs?

To begin with, apart from tax, there is no longer any compelling legal distinction between a non-publicly traded corporation and a non-publicly traded partnership that justifies the different tax rules that apply under present law to S corporations and partnerships. There are many of these, including the different treatment of foreign and tax exempt investors, the different treatment for payroll tax purposes, the different treatment of property distributions and the different restrictions on allocations of items of a passthrough's income or loss.

Subchapter S was enacted in 1958 in order to allow "small" business owners to achieve limited liability by incorporating but without incurring corporate tax on the corporation's income. Limited liability companies have since eliminated the need for Subchapter S. The only non-tax difference today between an S corporation and a limited liability company is that one is incorporated and the other is not; but that difference, while unimportant as a

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Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at pages and pages 92 and 93.

[4] The S corporation changes in Option 1 come from H.R. 892, the S Corporation Modernization Act of 2013 (February 28, 2013). *See also*, the S Corporation Modernization Act of 2011 (April 12, 2011); and ABA Section of Taxation, Options for Tax Reform In Subchapter S of the Internal Revenue Code (April 10, 2013). In the case of the partnership changes, a number are proposals that were put forward in a 1997 Joint Committee paper but not enacted as part of the Taxpayer Relief Act of 1997 and others come from comments made over time by practitioners and academics. *See* Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCX 6-97), April 8, 1997, and the sources cited by the Technical Explanation on pages 20, 22, and 29, including William B. Brannan, The Subchapter K Reform Act of 1997, 76 Tax Notes 121 (April 7, 1997).

practical matter, results in significant Federal income and payroll tax differences because of the different tax rules that apply to S corporations and partnerships. At the same time, the complexity of the partnership rules has grown exponentially over the last 50 years.

Option 2 offers the opportunity to address the Federal income tax aspects of this issue by putting in place a single set of tax rules for all non-publicly traded entities. It would also level the playing field by allowing non-publicly traded corporations that are now caught in Subchapter C (because, *e.g.,* they have foreign or other ineligible shareholders) to move into the new passthrough regime. And it would (because of its restrictions on allocations of a passthrough's items of income and loss and its treatment of property distributions by a passthrough) significantly simplify the present Subchapter K rules.

While there have been many proposals for reforming subchapter K, few are as straight-forward as option 2.[5]

Implementing Option 2 will require a lot of work and some difficult decisions. There are a number of issues that are explicitly "unaddressed" by option 2 (such as mergers, divisions and reorganizations; entity level determinations of a passthrough's income and loss; the treatment of foreign and tax exempt owners; and payroll taxes) or which need more clarity (such as the determination of when a corporation is publicly traded (and why the rule should differ from that which applies to partnerships), the "single distributive share" rules that applies to allocations of a passthroughs income or loss to the owners).

Let me quickly mention four that are important.

I: <u>Parity between investors</u>

It is important to provide the same tax treatment for investors in passthroughs that are corporations and passthroughs that are partnerships since

[5] While the Staff of the Senate Finance Committee has released a number of "Tax Reform Options for Discussion," those released so far do not include structural changes to Subchapters K or S.

otherwise the choice of a corporation or a partnership will distort investment decisions and access to capital.[6]

For example, it would make no sense for the rules that apply to foreign owners to differ depending on whether the passthrough was a corporation or a partnership. Foreign owners should be treated the same in either case. The choice here is between retaining and extending the existing partnership rule, which attributes partnership activities to the foreign partners for the purposes of determining whether the partner is engaged in a U.S. business and imposes the tax on the partner,[7] or replacing that rule by a withholding tax on distributions and an entity level tax on the foreign owner's share of undistributed income and gain recognized by a foreign partner on a sale of an ownership interest.

If there is tax exempt owner of a passthrough, there also should be parity between a passthrough corporation and a passthrough partnership. It seems clear under option 2 that the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the Section 512(b) "modifications" or from the other operations of the passthrough.[8] This is, of course, the rule that now applies to partners, and (although not in the same way)[9] to S corporation shareholders.

A related issue is the treatment of ESOP shareholders of an S corporation. Although not addressed by the draft, it would seem from what is there in the draft that the special rules for ESOP shareholders of an S corporation[10] may no

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[6] This is also an issue for investments in U.S. real estate made directly, through a partnership and through a real estate investment trust.

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

[8] Using the analysis of Rev. Rul. 74-197.

[9] The tax on unrelated trade or business income is applied to partners on a look through basis but Section 512(e)(1) treats all income of a tax-exempt shareholder of an S corporation as unrelated business income.

[10] In Section 512(e)(3).

longer apply, which will be an important issue for S corporations with ESOP shareholders – and there is an active ESOP lobby.[11] The effect of Section 512(e) is to eliminate any current tax on an ESOP shareholder's share of the income of an S corporation – that is, to defer any tax until there are distributions by the ESOP.

II: Payroll taxes

A second issue is the payroll tax.. The tax base for the self-employment tax that generally applies to partners in a partnership is net earnings from the trade or business carried on by the partnership; in the case of an S (or other) corporation, however, the FICA base is "wages", *i.e.*, remuneration for personal services. The difference is significant since the SECA base can both overstate and understate compensation for personal services, and the determination of what are reasonable "wages" is a complicated and much-litigated issue.

If there is a single passthrough system for Federal income tax purposes, it would certainly be odd to continue to have two rules for Federal employment tax purposes – that is, FICA for corporations and SECA for partnerships. And the Ways and Means Committee release that accompanied the draft seems to acknowledge this when it says (emphasis added) that Option 2 "requires *new* rules for the employment and self-employment taxes of owners."

This could, of course, be a major issue for S corporations since they are perceived as offering the opportunity to limit the FICA base.

Resolving the payroll tax issue may force a choice between applying the SECA base to *all* passthroughs or developing an administrable "reasonable

[11] *See*, *e.g.,* Comments submitted by The ESOP Association to the House Ways and Means Committee pension/retirement tax reform task force, Tax Notes Today, April 2, 2013; and S. 742, the Promotion and Expansion of Private Employee Ownership Act (April 17, 3013), supported by the Employee-Owned S Corporations of America.

compensation test" that could be applied to all passthroughs, as well as to C corporations.[12]

Related to the broad payroll tax question is the treatment of limited partners for self-employment tax purposes. There is now a rule, enacted in 1977 to address an issue that is no longer relevant, which allows an individual to exclude from the self-employment tax income derived as a limited partner unless it is a guaranteed payment for services actually rendered.[13] The draft does not seem to affect the exclusion. If the issue is addressed, which it should be, it seems self-evident that the exclusion should be limited to income derived for the use of capital invested as limited partner (and not apply to any other income).

III: Audits and determinations of taxable income or loss

A third issue is whether the final determination of an owners' items of income, gain, expense and loss from a passthrough will be made at the passthrough level or, as under present law (and subject to some restrictions), separately by each owner. The draft's proposed withholding tax points in the direction of an entity-level determination, which is a sensible way to reduce the complexity of present law and consistent with the purpose of the new withholding tax, which is to "Close the tax gap."[14] Thus, the owners' items of income, gain, expense and loss would be determined and audited at the passthrough level.

IV: Foreign income

Finally, the discussion draft does not address the disparity in the treatment of foreign income that will result if (as the Ways and Means Committee has

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[12] *See, e.g.,* Willard B. Taylor, Payroll Taxes – Why Should We Care? What Should be Done? , 137 Tax Notes 983 (2012).

[13] Section 1402(a)(13).

[14] *See* the Ways and Means Committee release. The reference to the tax gap is presumably a reference to underreporting of business income by individuals, which is consistently the largest component of the gap. *See* IR-2012-4, Jan. 6, 2012.

previously proposed) active foreign income of a C corporation's foreign subsidiaries is eligible for a 95% dividends received deduction – no dividends received deduction would be allowed to a passthrough.[15] This is a difficult issue since, if dividends to shareholders of a C corporation are taxed at capital gains rates, the effective U.S. tax on foreign earnings may be significantly less for a C corporation than for a passthrough, although that will of course depend on what happens to individual and corporate tax rates (and does not consider foreign taxes). The Ways and Means Committee release lists the taxation of foreign operations as a so-far-"unaddressed" issue.

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As Chairman Tiberi said in the release announcing this hearing, S corporations and partnerships are hugely important and need to be addressed. Passthroughs – whether S corporations or limited liability companies or partnerships – are a large and growing segment of the economy, and this is not likely to change.

In number, there were more than 4 million S corporations and 3 million partnerships (of which 1.9 million were limited liability companies) in 2008.[16] Between 1980 and 2007, passthroughs' percentages of business tax returns by number and of business receipts grew from 14.8% and 7.4%, respectively, to 22.8% and 34.1%, primarily because of the growth of S corporations (and notwithstanding the check-the-box regulations).

Will the enactment of option 2 slow the trend to passthroughs? Whatever the criticisms of option 2, a C corporation would not seem to be a better choice for small business. And S corporations, which have been the leading choice for privately held businesses, would likely find new Subchapter K more accommodating than Subchapter S. The complexity of new Subchapter K – *e.g.*,

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[15] Ways and Means Committee International Tax Reform Discussion Draft (October 26, 2011).

[16] There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. The shift from C corporations has contributed to the decline to about 10% in corporate tax revenues as a component of Federal tax revenues.

the possibility of special allocations within the single distributive share rule – is purely optional and is unlikely to be a deterrent (and the view that option 2 will inevitably increase tax compliance costs is not supportable).[17] If small C corporations (those with less than $100 million of assets) were to become passthroughs, passthroughs would account for more than 50% of total business receipts. [18]

Thank you.

I have also submitted, as my written comments, an outline used in a presentation of the discussion draft at NYU Law School. This includes more detailed comments on the draft.

[17] What happens, of course, will depend on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes. The House-passed budget would reduce the corporate rate to 25% and have two individual brackets, 10% and 25%. H. Con. Res. 112 (March 2013).

[18] Congressional Budget Office, Taxing Business Through the Individual Income Tax (December 2012) at page 10.

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Written Comments

1. Structure of the Ways and Means Committee Draft. The House Ways and Means Committee discussion draft of "Provisions To Reform the Taxation of Small Businesses and Passthough Entities," released on March 12, 2013, includes (apart from provisions directed at small businesses[19] and changes to the dues dates for business tax returns) two options for structural reform. One would make specific changes to the S corporation and the Subchapter K partnership rules (Option 1); and the second, while incorporating the Option 1 changes, would go much further and fundamentally redo Subchapters K and S, resulting in a single set of rules for all non-publicly traded passthroughs (Option 2) and publicly-traded partnerships that met the "good" income exception to the rule that generally treats publicly-traded partnerships as corporations.[20] There is no revenue estimate for either option. The changes would take effect in 2014, without any grandfathered exceptions (although the Ways and Means Committee release lists "Transition rules… with a goal of minimizing disruption" as a so-far-"unaddressed" issue).
2. Option 1. The specific changes in Option 1 are now new – they are essentially items that have been put forward for some time. In the case of S corporations, Option 1 would make most of the industry-backed changes that are in the S Corporation Modernization Act of 2013 and its predecessors.[21] In the case of

[19] Such as the expensing of certain expenditures and the use of cash method accounting.

[20] In Section 7704 of the Code.

[21] H.R. 892, the S Corporation Modernization Act of 2013 (February 28, 2013), which would (1) permanently reduce to 5 years the gain recognition period for built-in gain, (2) eliminate the rule that disqualifies an S corporation if has accumulated earnings and profits and its passive income is more than 25% of its gross receipts for 3 consecutive years, (3) raise from 25% to 60% of gross receipts the threshold for taxing an S corporation that has accumulated earnings and profits on net passive income, (4) allow and electing small business trust that is an S corporation shareholder to have a nonresident alien as a potential current beneficiary, (5) allow an electing small business trust to take a charitable deduction under the rules that apply to individuals, (6) make permanent the reduced basis adjustment to a shareholder's shares resulting from a charitable contribution by an S corporation of appreciated property, and (7)

partnerships, Option 1 would make more significant changes, although still largely clean ups. They are set out at the end of this outline. There is no single source for the partnership changes -- a number are proposals that were put forward in a 1997 Joint Committee paper but not enacted as part of the Taxpayer Relief Act of 1997 and others come from comments made over time by practitioners and academics.[22]

3. Option 2 – Fundamental Reform. Option 2 would be much more significant, both for partnerships and S corporations, and its economic importance should not be underestimated. Passthroughs – whether S corporations or limited liability companies or partnerships – are a large and growing segment of the economy, and this is not likely to change.[23]
    a. In 1980, C corporations accounted for 16.6% in number of business tax returns and 86.2% of business receipts; S corporations accounted for 4.2% in number of business tax returns and 3.2% of business receipts; and partnerships accounted for 10.6% in number of business tax returns and 4.2% of business receipts. By 2007, S corporations accounted for 12.8% of business tax returns and 19.8% of business receipts; partnerships accounted for 10% of business tax returns and 14.3% of business receipts; and C corporations accounted for 5.62% of business tax returns and 72.1% of business receipts.

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extend the time for making an S corporation election to the due date for the filing of the corporation's return. *See also*, the S Corporation Modernization Act of 2011 (April 12, 2011); and, ABA Section of Taxation, Options for Tax Reform In Subchapter S of the Internal Revenue Code (April 10, 2013).

[22] *See* Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCX 6-97), April 8, 1997 (hereafter, "JCX-6-97"), and the sources cited by the Technical Explanation on pages 20, 22, and 29, including William B. Brannan, The Subchapter K Reform Act of 1997, 76 Tax Notes 121 (April 7, 1997). On the fate of the Joint Committee proposals, *see* John S. Pennell and Philip F. Postlewaite, Subchapter K - Have The Joint Committee Proposals and TRA '97 Given It A New Look?, 87 J. Tax'n 325 (1997).

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

b. Thus, passthroughs' percentages of business tax returns by number and of business receipts grew from 14.8% and 7.4% to 22.8% and 34.1%, primarily because of the growth of S corporations (and notwithstanding the check-the-box regulations).

c. In number, there were more than 4 million S corporations and 3 million partnerships (of which 1.9 million were limited liability companies) in 2008. There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. The shift from C corporations has contributed to the decline to about 10% in corporate tax revenues as a component of Federal tax revenues.

4. What Does Option 2 Do? Option 2 would replace Subchapters K and S with a new Subchapter K that would apply to partnerships that were not publicly-traded (or, if publicly-traded, were still partnerships because of the "good" income exception in Section 7704(c) to the rule that generally treats publicly-traded partnerships as corporations) and be available to any corporation, other than one not eligible to be an S corporation under present law,[24] if it was not publicly traded and elected to be taxed under the new rules.[25] This would (outside of subchapter M, *i.e.*, RICs and REITs) then be the exclusive passthrough regime for corporations and partnerships.

   a. Option 2 would generally not change the definition of a partnership, the definition of what is an "entity" that is subject to classification as a partnership or a corporation (such as a "cell" company), or the treatment of "disregarded" entities.[26] Foreign corporations would be eligible to be passthrough entities, if not publicly traded, even though

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

[25] An existing S corporation would be deemed to elect unless it affirmatively elected not to be a passthrough corporation. A passthrough election by a corporation can be revoked only with IRS consent.

[26] This may be an issue because of the ease with which a disregarded entity could be turned into a partnership. *See* Monte A. Jackel, A Short Journey Into Some Needed Reforms in the Partnership World, Tax Notes Today, October 22, 2012.

per se corporations sunder the Section 7701 regulations.[27] Option 2 keeps the statutory exclusions from partnership classification that are in Section 761,[28] and it would also keep Section 704(c), relating to "family partnerships," but only in a case where an individual (as opposed to, *e.g.*, a corporation) acquired a capital interest in a passthrough from another family member.[29]

5. When is a corporation publicly-traded? The Technical Explanation says that, in the case of a corporation, the definition of publicly-traded is "intended to be broader than the definitions under present law," and the proposed definition refers specifically to Section 1273(b), as well as to Section 7704.[30] The Section 1273(b) regulations treat instruments as publicly traded if there is a sale, a firm quote or an indicative quote. The rules focus on whether there is a reasonable basis to determine value and are inclusive.[31] The focus of the

[27] This may (like the check-the-box regulations) increase international arbitrage – that is, situations in which an entity is a corporation for foreign tax purposes but a passthrough in the US.

[28] As under present law, partnerships would not include unincorporated entities described in paragraphs (a), (b), or (c) of Section 761(a) – *i.e.*, at the election of all the members, an organization availed of for investment purposes only, for the joint production, extraction or use of property or by dealers in securities for a short period for the purpose of underwriting or distributing a particular issue of securities. The Section 761(f) exclusion for joint ventures between a husband and wife remains.

[29] Thus putting to rest the taxpayer's argument in TIFD III-E, Inc. v. U.S., 666 F. 3rd 836 (2d Cir. 2012).

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

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

Section 7704 regulations is different, *i.e.*, not on determining value but on whether there are readily available, regular and on-going opportunities to sell. The broader definition will limit the population of corporations that can move into Subchapter K, possibly even excluding some existing S corporations.

6. Moving In and Out of New Subchapter K. Under Option 2, an election by an corporation (whether a C or formerly an S corporation) to be a passthrough would not be a taxable event (although the special rules that apply to built-in gains and to passive income of, or distributions by, corporations with accumulated earnings and profits would, as modified under Option 1, remain).[32] Thus, an S corporation could generally move into new Subchapter K without interrupting its passthrough treatment. Nor would there be a taxable event if a passthrough corporation or partnership no longer qualified as a passthrough (*e.g.*, it became publicly-traded) and moved out of new Subchapter K – *i.e.*, was henceforth treated as a corporation. Whether a partnership that was or became publicly traded would be classified as a C corporation or not would continue to depend on whether it met the "good" income exception in Section 7704(c) to the rule that generally treats a publicly-traded partnership as a corporation. Unless it ceased to be publicly-traded, an existing publicly-traded corporation could not move into new Subchapter K without a taxable liquidation since the passthrough election is available only if the corporation is not publicly traded; and, if it did liquidate, it would of course have to meet the "good" income exception in Section 7704(c) to be classified as a partnership.[33]

[32] That is, the rules that (1) tax passive income if the passive income of such a corporation is more than 60 % of its gross income, (2) tax such a corporation on built-in gain if the property is disposed of within 5 years, (3) require a former C corporation to keep an accumulated adjustments account in order to segregate C corporation earnings and profits (and tax distributions out of that account as dividends), and (4) require the recapture of LIFO reserves when a C corporation becomes a passthrough entity. In addition there would be no carryover of C corporation losses to the passthrough entity or from a passthrough entity to a C corporation.

[33] And thus publicly-traded partnerships that wanted to be passthroughs would, as today, choose to become real estate investment trusts if able to qualify.

7. Impact of Option 2. The effect of Option 2 would be to change significantly the treatment of partnerships and of non-publicly traded corporations that elect to be passthroughs. While there have been many proposals for reforming subchapter K, few are as straight-forward as this.[34]
    a. Thus, in case of S corporations, the one-class-of-stock and shareholder-level eligibility rules (not more than 100 shareholders, consisting of specified trusts and estates and exempt organizations, but otherwise only individuals who are residents or citizens) are eliminated, as is the "back-to-back" loan issue (since debt of a corporations that was a passthrough is treated in the same way as debt of a partnership passthrough and thus can be included in the owner's basis).[35] There would be no more QSubs (although disregarded entities would be available, as would passthrough corporations if treated in effect as disregarded entities); no ability to use an S corporation as a "mixing bowl;" no Section 338(h)(10) elections; and no more tax-free reorganizations or spin offs, except to the extent feasible under new Subchapter K (as opposed to Subchapter C).
    b. In the case of a partnership, the most significant changes are (1) new restrictions on allocations of passthrough items to owners and (2) importing the S corporations rule, the recognition of gain by the passthrough and gain (and sometimes loss) by the owner on a distribution of property.
8. New Subchapter K. The Option 2 rules for passthroughs include all of the changes to present Subchapter K, *i.e.*, to partnerships, that would be made by Option 1 (as set out at the end of this outline), and in addition the following:

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[34] As one exception, *see* Walter D. Schwidetzky, Integrating Sub-chapters K and S - Just Do It, 62 Tax Lawyer 749 (2009). While the Staff of the Senate Finance Committee has released a number of "Tax Reform Options for Discussion," those released so far do not include structural changes to Subchapter K or S.

[35] *See* the Ways and Means Committee release stating that Option 2 will "Conform [S corporations] to the basis rules that currently apply to partnerships".

a. Single Distributive Shares. While the passthrough rules (*i.e.*, what passes through to an owner, the retention of its character and source, etc.) are not changed,

   i. an owner's distributive share will henceforth be determined on the basis of its "economic interest" in the partnership;

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

   iii. an owner's distributive share of foreign income taxes (and thus the related deduction or credit) will be based on the owner's share of the passthrough items on which the foreign taxes were imposed.[36]

   iv. The statute contemplates that regulations will prevent the avoidance of the restriction on distributive shares through, *e.g.*, the use of passthroughs under common control.

b. Impact on partnerships. The single distributive share rule (which is intended to "Reduce the use of complex structures to engage in tax avoidance")[37] will, for example, prevent the splitting between owners of ordinary deductions, such as depreciation, and ordinary income; of capital losses and capital gains; or of foreign and domestic source ordinary income.[38] That is a major change for partnerships – many of

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[36] This seems to be more or less the same as the rule now in Regs. §1.704-1(b)(4)(vii)(a); and it puts to rest foreign tax credit structures like that in Pritired 1, LLC v. U.S., 816 F. Supp. 2d 693 (S.D. Iowa 2011).

[37] From the Ways and Means Committee release that accompanied the draft.

[38] *See* the one example in the Technical Explanation -- "Assume passthrough AB has 2 owners, A and B. The passthrough has the following items related to its leasing activities: $ 100 of rental income and depreciation expense of $ 50, for a net income of $ 50 from the leasing activity. The passthrough also receives $ 50 royalty income. A's economic interest in the passthrough is with respect to the leasing activity, while B's economic interest in the passthrough is with respect to

the illustrations in the current Section 704(b) regulations would be closed down before being evaluated to determine whether they have "substantial economic effect".[39] Conversely, it may restrict the flexibility that partnerships now provide – for example, where a professional services firm has nonresident alien and US partners and allocates foreign source income to the foreign partners.[40]

c. Impact on S corporations. The single distributive share rule is obviously much less important for passthrough corporations, since (under Subchapter S) they are now limited to one class of stock. With the changes made by Option 2, a corporation that elects into Subchapter K will be able to have more than one class of stock. This is important – S corporation banks, for example, have urged that they be able to issue preferred stock and that would be feasible under Option 2.

d. Are there are holes and/or unresolved issues in the single distributive share rule?

    i. For example, where is tax-exempt interest? Possibly in the ordinary income share, since that is "any passthrough item which is not in" another share – but does it make sense to combine tax-exempt interest with other ordinary items?

    ii. The distributive shares focus on individual tax rates – do they make sense for corporate partners? For example, in the case of a corporate owner, does it make sense to group dividends that are eligible for the dividends received deduction with net capital gain, which is taxed at the same rate as ordinary income?

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the intellectual property giving rise to the royalty income. Thus, of the $ 100 total passthrough net income, A and B each have $ 50, or 50 percent each. For purposes of applying this section, A's and B's distributive shares of $ 50 are each comprised of 50 percent of each ordinary passthrough item, specifically, $ 50 of rental income (50 percent of the $ 100 of rental income), $ 25 depreciation expense (50 percent of the $ 50 depreciation expense), and $ 25 royalty income (50 percent of the $ 50 royalty income)."

[39] *E.g.,* Examples (1), (3), (10) and (12) of Regs. §1.704-1(b)(5).

[40] Example (10) of Regs. §1.704-1(b)(5). The release notes, however, that the "proper treatment of …foreign partners" is a so-far-"unaddressed" issue.

iii. Is the single distributive share rule for each year or for longer? Shifting, or transitory, allocations that change from year to year are, of course, an important focus of the "substantial economic effect" rules.

iv. Why are credits a separate distributive share, at least if (like the research expenditure credits, for example) they are based on expenditures that are included in the ordinary items distributive share?

v. And, out of curiosity, where did the single distributive share rule come from? [41] Is it in part a product of the proposed withholding tax?

9. Other allocation rules? It is unclear to what extent, apart from the single distributive share rule, there will be a change in the present partnership allocation rules – the distributive shares still have to be tied to something, such as capital accounts, which is presumably what the "economic interest" rule will require. On the other hand, "substantial economic effect" is eliminated; and, without elaboration of what "economic interest" means (beyond that it is to be determined on the basis of "all the facts and circumstances"), the effect of this is uncertain. Liabilities are not mentioned in the Technical Explanation (and Section 752 is not changed).

10. Gain or Loss on Property Distributions by a Passthrough**.** Gain (but not loss) is recognized by a passthrough entity on a distribution of property to the owners, and gain or loss is recognized by an owner on the receipt of property distributed by the passthrough (but with the loss deferred until the termination of all of the owner's direct or indirect interest in the passthrough). The basis in loss property to the owner cannot exceed the owner's basis in the owner's interest in the passthrough. The Ways and Means Committee release describes these changes as intended to "Prevent owners from gaming the tax

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[41] *See*, as one possibility, the default rule (all "tax allocations ratably based on [the] partners' relative capital account balances") suggested by Andrea Monroe, Too Big To Fail: The Problem of Partnership Allocations, Virginia Tax Review, Winter 2010, available on SSRN, and the other proponents of similar rules listed in footnote 168 of that article.

system by using losses to reduce tax liability," to "Ensure that taxes are paid on real, economic gains," and to "Prevent the use of pass-through entities to shift gains and losses amongst owners with different tax profiles."

a. Mergers, divisions and reorganizations. How will the gain/loss recognition rules affect passthrough mergers, divisions and reorganizations?

   i. "Mergers, divisions, and reorganizations" is listed as a so-far-"unaddressed" issue. The need to do so is evident – whether a passthrough is a corporation or partnership, a merger (whether, in the case of a partnership, it is an "assets over" or "assets up" transaction), division or reorganization may involve transfers of assets, exchanges of ownership interests and/or distributions of property. Under the general rules of new Subchapter K, some of these, including distributions of property,[42] will result in the recognition of gain unless there are separate rules.

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

b. Other Changes. Leaving aside the changes that would be made by Option 1 and are also included in Option 2, most of the other rules in new subchapter K are described by the Technical Explanation as "similar to," "consistent with," or "as in present law," with those in existing subchapter K .[43]

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

[43] For example, the exclusions from passthrough classification in Sections 761(a) and (f), the Section 704(c) rules for contributed property, the basis limitation on an owner's share of a

11. Withholding Tax on an Owner's Distributive Share and the Determination of a Passthrough's Income. Under Option 2, a passthrough will be required to withhold tax, at a rate to be specified, on an owner's distributive share of the entity's net income (treating ordinary income and capital gain items separately) unless the income is subject to withholding under Section 1446, which imposes withholding tax on foreign partners in a partnership. It seems unlikely that the intention is to apply Section 1446 only to foreign partners in a partnership passthrough, as opposed to foreign owners of a passthrough, whether it is a corporation or a partnership, but this is not clearly stated.
    a. The new withholding tax is intended to "Close the tax gap"[44] – presumably a reference to underreporting of business income by individuals, which is consistently the largest component of the gap.[45].
    b. The new withholding tax will be treated as a distribution for the purpose of determining the owner's basis in the owner's interest and as tax paid by the owner. The credit allowed to the owner for the tax withheld is refundable. The tax is treated as imposed on the passthrough entity under Section 11 and the failure to pay the tax is treated as a failure to pay estimate corporate income tax.
12. Entity level determinations? New subchapter K does not include the electing large partnership provisions of subchapter K[46] (or the Administration's

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passthough's loss, the nonrecognition of gain or loss on a contribution of property to a passthrough, the basis of the contributed property to a passthrough, the basis of the contributing owner's interest when there is a contribution of property, the character of gain or loss on contributed receivables, etc., the Section 707(a) and (b) rules on transactions between passthroughs and owners, the closing of a passthrough's taxable year, and the determination of an owner's distributive share when the owner's interest in the passthrough changes. Likewise, the passthrough rules relating to built-in gain or accumulated earnings and profits of a C corporation that becomes a passthrough are described as similar to those that apply when a C corporation becomes an S corporation.

[44] *See* the Ways and Means Committee release.

[45] See IR-2012-4, Jan. 6, 2012.

[46] Sections 771-76.

proposals with respect to audits, etc. of large partnerships).[47] Because the new withholding tax is determined at the level of the passthrough entity, however, there is an entity level determination of that tax and of the items that make up the amount subject to withholding. This would seem to eliminate any owner participation in the determination of the base for the withholding tax.[48] The Ways and Means Committee release asks, nonetheless, whether the IRS should "be permitted to audit and assess tax liability at the entity level."

13. Will Passthrougths Continue to Grow? Would the enactment of Option 2 slow the trend to passthroughs? Whatever the criticisms of Option 2, a C corporation would not seem to be a better choice for small business. And S corporations, which have been the leading choice for privately held businesses, would likely find new Subchapter K more accommodating than Subchapter S. The complexity of new Subchapter K – *e.g.*, the possibility of special allocations within the single distributive share rule – is purely optional and is unlikely to be a deterrent. What happens, of course, will depend on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes. (The House-passed budget would reduce the corporate rate to 25% and have two individual brackets, 10% and 25%.)[49] If small C corporations (those with less than $100 million of assets) were to become passthroughs, passthroughs would account for more than 50% of total business receipts.

14. Regulated Investment Companies, Real Estate Investment Trusts, and Publicly-Traded Partnerships. Option 2 would not affect regulated investment companies or real estate investment trusts (except in so far as it makes permanent the 5 year gain recognition period for built-in gain) or, generally,

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[47] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 188. Nor does it mention the TEFRA partnership audit provisions.

[48] It is not clear whether this would extend to the Section 1446 withholding tax.

[49] H. Con. Res. 112 (March 2013). These are the rates targeted by the Ways and Means Committee.

the status of publicly-traded partnerships that are treated as partnerships for tax purposes because of the "good" income exception in Section 7704(c) to the rule that generally treats publicly traded partnerships as corporations. The draft does not address those publicly traded partnerships but, unless the rules were changed, their operations would henceforth be subject to the rules of new Subchapter K (and no changes are made to rules that publicly-traded partnerships may find annoying, such as the rule in Section 708(b)(1)(B) which terminates a partnership if there is a sale or exchange of 50% or more of the ownership interests during the year).[50] RICs, REITs and publicly-traded partnerships that are shareholders of a passthrough corporation would seem to be treated no differently than if they were partners in a non-publicly traded partnership. Since passthrough treatment of a corporation is elective, however, they could continue to have corporate subsidiaries, including taxable REIT subsidiaries, as "blockers." Taxable mortgage pools may have to be addressed if Option 2 moves forward.[51]

15. Attribution To Owners of a Passthrough's Activities. Will a passthrough's activities be attributed to the owners (as is now the case for partnerships) if the passthrough is a corporation?[52] This is important in a number of contexts, including where there are foreign or tax exempt owners.

    a. Foreign owners. If there are foreign owners, for example, the present partnership rules (1) treat a foreign partner in a partnership as engaged in a US trade or business if the partnership is so engaged,[53] and (2) treat a sale of an interest in a partnership as a sale of the partner's share of the assets of the partnership that are effectively connected, whether

[50] The partnership allocation rules of Option 2 may affect iShare structures that some publicly traded partnerships use to attract tax exempt investors – *i.e.*, the partnership allocations between the issuer of the iShares and the partners in the publicly traded partnership.

[51] A taxable mortgage pool is *per se* a corporation, under Section 7701(i), but may not be publicly-traded.

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

[53] Section 875(1).

because of FIRPTA or otherwise.[54] The Ways and Means Committee release lists the treatment of foreign owners as a so-far-"unaddressed" issue. It would be odd, however, if the rules differed for a passthrough corporation and a passthrough partnership, and aligning the rules would offer an opportunity to achieve parity between foreign partners and foreign shareholders by, for example, making the withholding tax a definitive tax.

b. Tax exempt owners. If there are tax exempt owners of a passthrough, it seems clear that the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the Section 512(b) "modifications" or from the other operations of the passthrough.[55] This is, of course, the rule that now applies to partnerships. The Ways and Means Committee release asks whether the withholding tax should be applied to "tax-indifferent owners, such as pension funds" -- it would seem that it should (although possibly in a modified form), so long as there is a tax on unrelated business taxable income.

    i. ESOPs, etc. The special rules in Sections 512(c) and 512(e) that apply to tax exempt and ESOP shareholders of an S corporation may no longer apply, which will be an important issue for S corporations with ESOP shareholders – and there is an active ESOP lobby.[56] The effect of Section 512(e) is to eliminate any current tax on an ESOP shareholder's share of the income of an S

[54] Rev. Rul. 91-32, which would be codified by the Administration's fiscal 2014 budget proposals. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 57.

[55] Using the analysis of Rev. Rul. 74-197.

[56] *See*, *e.g.,* Comments submitted by The ESOP Association to the House Ways and Means Committee pension/retirement tax reform task force, Tax Notes Today, April 2, 2013; and S. 742, the Promotion and Expansion of Private Employee Ownership Act (April 17, 3013), supported by the Employee-Owned S Corporations of America.

corporation – that is, to defer any tax until there are distributions by the ESOP.

16. What's Left Out? There have been from time to time other proposals to change specific Subchapter K rules that are not included in Option 2, such as to repeal or modify the technical termination rule in Section 708(b)(1),[57] to eliminate the anti-abuse regulations and to take a consistent approach to the aggregate-or-entity issue,[58] to make more inclusive the "investment company" definition in Section 721(b),[59] and to accommodate some of the problems faced by publicly-traded partnerships covered by the "good" income exception in Section 7704(c) (such as the determination of distributive shares when interests are regularly purchased and sold and the treatment of interests in a publicly-traded partnership as "securities" for purposes of Section 1058). Nor does Option 2 does address the hot-button issue of carried interests and, since subchapter K is the starting point for new Subchapter K, it might be interpreted as expanding the issue to include interests in passthrough corporations.[60]

17. Other questions. Option 2 leaves open a large number of questions, apart from those mentioned above, such as the application of the partnership anti-abuse rules and the circumstances in which a partnership will be treated as an entity or an aggregate – without more, it would be logical to assume these rules now apply to passthrough corporations. It also leaves open a number of matters not as such addressed by subchapters K or S, other than those mentioned above, including

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[57] *E.g.,* Monte A. Jackel, *supra* note 7; JCX-6-97 at 40. This would be repealed by the Administration's fiscal 2014 budget proposals. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 231.

[58] Id.

[59] See NYSBA Tax Section, Report No. 1252, Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F) (December 28, 2011).

[60] This is addressed by the Administration's fiscal 2014 budget. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 159.

a. Employment Taxes and Related Matters. The different treatment of partnerships and corporations under SECA and FICA,[61] and for purposes of provisions such as Section 469 or 1411, are not addressed. The SECA/FICA divergence is noted in the Technical Explanation and listed as a so-far-"unaddressed" issue in the related Ways and Means Committee release. If there is a single passthrough system for Federal income tax purposes, it would certainly be odd to have two rules for Federal employment tax purposes -- that is, FICA for corporations and SECA for partnerships. And the Ways and Means Committee release that accompanied the draft seems to acknowledge this when it says (emphasis added) that Option 2 "requires *new* rules for the employment and self-employment taxes of owners." This could, of course, be a major issue for S corporations since they are perceived as offering the opportunity to limit the FICA base.

    1. Limited partner exclusion. Absent new rules, because of the draft's repeal of the guaranteed payment rule, the exception to the Section 1402(a)(13) exclusion for limited partners will, under the draft, be for payments made to an owner for services rendered by the owner in a non-owner capacity. The Section 1402(a)(13) exclusion from the SECA base will otherwise remain, and the draft is also clear that an owner may be an employee of a passthrough partnership and thus earn "wages" subject to FICA.[62]

b. Foreign Operations. The discussion draft does not address the disparity in the treatment of foreign income that will result if (as the Ways and Means Committee has previously proposed) active foreign income of a C

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

[62] *See* the Ways and Means Committee release ("Provide certainty with respect to owners who actively participate in the business by allowing owners to be treated as employees of the business.")

corporation's foreign subsidiaries is eligible for a 95% dividends received deduction – no dividends received deduction would be allowed to a passthrough.[63] This is a difficult issue since, if dividends to shareholders of a C corporation are taxed at capital gains rates, the effective U.S. tax on foreign earnings may be significantly less for a C corporation than for a passthrough, although that will of course depend on what happens to individual and corporate tax rates (and does not consider foreign taxes). The Ways and Means Committee release lists the taxation of foreign operations as a so-far-"unaddressed" issue.

c. Tax treaties. Treating US corporations as passthroughs is consistent with the right of the US to use its definitions in applying US tax treaties; and, in the case of inward investment, more recent US treaties (and, in any event, Section 894) apply uniform rules to fiscally transparent entities, whether incorporated or not.

d. State and local income taxes. Many states (including New York) have specific rules for S corporations (which sometimes include entity level taxes) and partnerships; and, if there is to be parity between non-publicly traded corporations and partnerships for State and local tax purposes, these rules would have to be conformed to new Subchapter K. In any event, the terms used in many state and local tax statutes (*e.g.*, references to S corporations) would have to be changed.

18. Conclusion. Subchapter S was enacted in 1958 in order to allow a "small" business owner to achieve limited liability by incorporating but without incurring corporate tax on the corporation's income. Limited liability companies have since eliminated the need for Subchapter S. The only non-tax difference today between an S corporation and a limited liability company is that one is incorporated and the other is not; but that difference, while unimportant as a practical matter, results in significant Federal income and payroll tax differences because of the different rules that apply to S corporations and partnerships.

[63] Ways and Means Committee International Tax Reform Discussion Draft (October 26, 2011).

a. Is Option 2 the solution?
b. Would it also level the playing field, *i.e.*, address the problems of small businesses caught in subchapter C?
c. Or, because it does not involve the complexity of addressing so many issues, would Option 1 be a better choice?

Option 1

These changes made to partnership taxation by Option 1 (and which are also included in Option 2) are

1. Guaranteed payments. On the basis that Section 707(a), relating to payments to partners not acting in that capacity, is sufficient, repealing Section 707(c), relating to guaranteed payments for services or the use of capital (because it has "created a great deal of uncertainty, confusion, and controversy").[64] Payments would simply be distributions to a partner unless covered by Section 707(a).
2. Mandatory adjustment to partnership property basis. Eliminating the elections in Sections 734 and 743, so that an adjustment to the basis of partnership property to reflect a sale of a partnership interest by a partner or the distribution of property by a partnership is mandatory, not elective or dependent on the built-in loss in partnership property after the distribution being "substantial";[65] and applying these rules to tiered partnerships. [66]
3. Eliminate time restrictions on mixing bowl provisions. Eliminating the 7 year restrictions on the "mixing bowl" rules (*i.e.*, the 7 year restrictions in Sections 704(c)(1)(B) and 737(b)(1)) on the allocation of pre-contribution gain or loss of property when the contributed property is distributed to another partner or other property is distributed to the contributing partner.
4. Hot asset rules. Broadening the "hot asset" rule in Section 751 so that it treats a distribution of inventory to a partner as a sale, whether or not the inventory has appreciated "substantially" and simplifying the

[64] See JCX-6-97 at 45.

[65] See JCX-6-97 at 27.

[66] See JCX-6-97 at 42.

definition of an “unrealized receivable” so that it includes any property to the extent of the amount that would be ordinary income on a sale. [67]

5. Deceased or retired partners. Repealing, as “obsolete,” Sections 736 and 753, relating to payments in the liquidation of a retiring or deceased partner’s interest and the treatment as income in respect of a decedent of amounts received as a successor in interest to a deceased partner.
6. Limiting a partner’s loss. Extending the rule that limits a partner’s loss to the partner’s basis in the partnership interest to deductions for charitable deductions and foreign taxes taken as a deduction (which is the rule that applies to shareholders of an S corporation).

[67] See JCX-6-97 at 43.