

Subchapter S: Vive le Difference!

*Roberta Mann**

No rational, reasonably well-informed tax professional would deliberately choose Subchapter S status over an LLC when there is a choice, and 99 percent of the time there is a choice The LLC is clearly the choice of the future if you are dealing with rational people, and most of the time we are dealing with rational people.¹

INTRODUCTION

From 1958 to 1996, S corporations were the only business form to combine limited liability with reliable pass-through tax treatment. In 1996, the Treasury and the Internal Revenue Service (IRS) promulgated the “check-the-box” regulations, and LLCs, taxed as partnerships, became the darlings of the tax world. Is Subchapter S² obsolete, or does it still serve a rational purpose in the economy? This Article will examine that issue, focusing on the comparison between S corporations and LLCs. The Article begins with a history of Subchapter S and the “check-the-box” regulations. Next, the Article will compare the arguments for and against repealing Subchapter S.

The chairman of the United States House of Representatives Ways and Means Committee, David Camp, published options for pass-through entity tax reform in March of 2013.³ One option (Camp Option 2) would repeal Subchapter S and replace it with a

* Roberta F. Mann is the Loran L. Stewart Professor of Business Law at the University of Oregon School of Law. Thanks to Mike Lang and Blake Corry for inviting me to participate in the symposium. Thanks also to Kelly Erb, Robert Morrow, Bahar Schippel, and especially Walter Schwidetzky for thoughtful comments. Any errors, omissions, mistatements or falsehoods are my responsibility, unless someone else would like to take the blame.

¹ Amy Hamilton, *S Corporations 'Most Popular Choice of Entity,' IRS Finds*, 88 TAX NOTES 157, 157 (2000) (quoting former Internal Revenue Service (IRS) Commissioner Donald C. Alexander).

² Subchapter S refers to the collection of provisions that govern the taxation of S corporations. I.R.C. §§ 1361–1379 (2012).

³ HOUSE COMM. ON WAYS & MEANS, 113TH CONG., DISCUSSION DRAFT ON TAX REFORM ACT OF 2013 (2013) [hereinafter WAYS & MEANS DISCUSSION DRAFT]; HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (2013) [hereinafter TECHNICAL EXPLANATION].

unified tax regime for pass-through business entities.⁴ This Article will examine Camp Option 2 with a view to informing the reader whether to praise or bury it. Statistics appear to show that the number of S corporation returns is still increasing.⁵ Why are S corporations still being used, and do those reasons justify its continued existence?⁶ Perhaps the answer is political: politicians love small businesses and S corporation stands for “small business.”⁷ Ultimately, the answer to these questions may depend on whether politicians’ favorable view of small business is justified.

I. HISTORY

A. Subchapter S

In 1958, Congress enacted the first version of subchapter S.⁸ Subchapter S created the first limited liability entity without an entity level tax. The term “small business corporation” has been part of subchapter S since its original enactment.⁹ President Eisenhower proposed subchapter S to help small businesses.¹⁰ The stated goals of the original legislation, as proposed by the Senate, were (1) to permit “businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences”; (2) to remove the “double” tax on distributed earnings; and (3) to benefit small businesses by allowing shareholders to use corporate losses.¹¹ The legislation limited the benefits of subchapter S to “small business” corporations by imposing a strict limitation on the

⁴ See *supra* note 3; see also Monte A. Jackel, *An Initial Look at Camp's Small Business Proposals*, 138 TAX NOTES 1363, 1363 (2013); George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358, 358 (2013); Willard B. Taylor, *Subchapter S Out the Window? What's Going On?*, 139 TAX NOTES 1051, 1052 (2013).

⁵ See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA 9–10 (2012).

⁶ See John W. Lee, *Choice of Small Business Tax Entity: Facts and Fictions*, 87 TAX NOTES 417, 425 (2000).

⁷ Mirit Eyal-Cohen, *Down-Sizing the “Little Guy” Myth in Legal Definitions*, 98 IOWA L. REV. 1041, 1047 (2013); Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1, 1 (2008) [hereinafter Eyal-Cohen I]; Martin A. Sullivan, *When Should Small Businesses Get a Tax Break?*, 134 TAX NOTES 267, 267 (2012); Martin A. Sullivan, *Why Not Tax Large Passthroughs as Corporations?*, 131 TAX NOTES 1015 (2011).

⁸ Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650 (current version at I.R.C. §§ 1361–1379).

⁹ *Id.*

¹⁰ The President’s budget message of January 13, 1958, stated, “There are certain technical tax revisions which will give substantial benefits to small business, with a minimum loss of revenue and with no changes in tax rates.” 104 CONG. REC. 388, 389 (1958), reprinted in 1958 U.S.C.C.A.N. 5360, 5364.

¹¹ S. REP. NO. 85-87, at 1008 (1983).

number of shareholders.¹² Originally, S corporations could have no more than ten shareholders,¹³ and that limit was strictly enforced by the Internal Revenue Service (IRS).¹⁴ In Revenue Ruling 77-220, three separate S corporations, each with ten shareholders, joined together in a partnership to operate a single business.¹⁵ The IRS found that the principal purpose for forming the three corporations was to avoid the ten-shareholder limitation and invalidated the S elections made by the three corporations.¹⁶ Revenue Ruling 77-220 has since been reconsidered by the IRS. In Revenue Ruling 94-43,¹⁷ the IRS decided that the separate S elections of the three corporations should be respected, stating that:

The purpose of the number of shareholders requirement is to restrict S corporation status to corporations with a limited number of shareholders so as to obtain administrative simplicity in the administration of the corporation's tax affairs [T]he fact that several S corporations are partners in a single partnership does not increase the administrative complexity at the S corporation level.¹⁸

Somehow, between 1977 and 1993, “small” changed meaning.¹⁹ But it is unclear whether “small” ever had a significant meaning in the statutory context of subchapter S. The definition of S corporation has never referred to the value of assets held by the corporation or the amount of contributed capital, unlike some other tax provisions.²⁰ Under current law, S corporations may have up to 100 shareholders, and members of a family may count as a single shareholder.²¹

¹² Technical Amendments Act of 1958 § 64.

¹³ *Id.*

¹⁴ Rev. Rul. 77-220, 1977-1 C.B. 263.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Rev. Rul. 94-43, 1994-2 C.B. 198.

¹⁸ *Id.*

¹⁹ The number of permitted shareholders increased to 15 in 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a)(1), 90 Stat. 1520, 1608); to 25 in 1981 (Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 233(a), 95 Stat. 172, 250); to 35 in 1982 (Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, 1669); to 75 in 1996 (Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777); and to 100 in 2004 (American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 232(a), 118 Stat. 1418, 1434) (current version at I.R.C. § 1361 (2004)).

²⁰ See, for example I.R.C. §§ 1202(a)(1), (d)(1) (2012) (allowing a 50% exclusion from gain recognized on the disposition of “small business stock”), defining “qualified small business” as a corporation with aggregate gross assets less than \$50,000,000, and I.R.C. §§ 1244(a), (c)(3)(A) (allowing an ordinary loss to be recognized on the disposition of “small business stock”), under which a corporation may only be treated as a “small business corporation” “if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000.”

²¹ I.R.C. § 1361(b)(1)(A), (c).

Professor Mirit Eyal-Cohen meticulously examined the history of the subchapter S provisions.²² She observed that there is no standard definition of “small business.”²³ Whether a business is considered “small” may depend on the number of employees, number of owners, value of total assets or annual sales.²⁴ Irrespective of the particulars of the definition, “[s]mall companies are the darlings of the business world. . . . [and] have semi-sacred status in the American political economy,” according to economist Martin Sullivan.²⁵ Prior to the original enactment of subchapter S, the welfare of small companies was considered to be “a key condition for prosperity.”²⁶ This view has only strengthened over time, as discussed by Eyal-Cohen.²⁷ She notes, “small business has been constantly portrayed as the source of innovation and change—firms that by their mere existence generate new value and novel ideas. Size has turned into a pivotal benchmark to indicate business novelty and positive contributions to the economy.”²⁸ Sullivan notes that “no politician of any persuasion wants to do anything but praise small businesses.”²⁹

B. Limited Liability Companies and Check-the-Box

The political attractiveness of small businesses that spurred the enactment of subchapter S attaches with equal fervor to a newer business entity, the limited liability company (LLC).³⁰ Like corporations, LLCs are creatures of state law.³¹ In 1977,

²² Eyal-Cohen I, *supra* note 7. However, most S corporations are held by three or fewer shareholders. S. REP. NO. 10-195, at 4 (2009).

²³ See Eyal-Cohen I, *supra* note 7, at 7; see also STAFF OF THE JOINT COMM. ON TAXATION, 112TH CONG., SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY 7 (2012) [hereinafter JCT]. The JCT found that a majority of S corporations could be considered “small,” as defined by having less than \$100,000 in assets. *Id.* at 8.

²⁴ Eyal-Cohen I, *supra* note 7, at 7.

²⁵ Martin A. Sullivan, *The Myth of Mom-and-Pop Businesses*, 132 TAX NOTES 1085, 1085 (2011).

²⁶ *Needed: Talent, Training & Tax Cuts*, TIME, Nov. 12, 1956, at 98.

²⁷ See generally Mirit Eyal-Cohen, *Down-Sizing the “Little Guy” Myth in Legal Definitions*, 98 IOWA L. REV. 1041 (2013) [hereinafter Eyal-Cohen II].

²⁸ *Id.* at 1054 (footnotes omitted).

²⁹ Martin A. Sullivan, *Start-Ups, Not Small Businesses, Are Key to Job Creation*, 134 TAX NOTES 158, 158 (2012).

³⁰ “Small businesses are almost always passthrough entities—subchapter S corporations, partnerships, or sole proprietorships.” Sullivan, *supra* note 7, at 267. Until 2011, the Treasury Department’s Office of Tax Analysis included as a small business owner any individual who received flow-through income from a partnership or S corporation. See Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce & Richard Prisinzano, *Methodology to Identify Small Businesses and Their Owners*, 4 OFF. TAX ANALYSIS TECHNICAL PAPERS, Aug. 2011, at 2.

³¹ *E.g.*, ROBERT W. HAMILTON, JONATHAN R. MACEY & DOUGLAS K. MOLL, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 136, 1183 (11th ed. 2010).

Wyoming was the first state to enact LLC legislation.³² At the time, the IRS decided how to tax business entities by applying the so-called *Kintner* regulations.³³ The regulations identified four corporate characteristics: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) freely transferable interests.³⁴ If an entity had three corporate characteristics, it was taxed as a corporation.³⁵ If it had two or fewer corporate characteristics, the IRS would disregard it for tax purposes if it had a single owner, or tax it as a partnership if it had more than one owner.³⁶ The regulations intentionally made it more difficult to obtain corporate tax treatment. Until 1986, the corporate tax rate was significantly below the top marginal rate applied to individuals.³⁷ Thus, wealthy individuals used corporations as tax shelters, keeping personal assets in the corporations and deferring individual tax liability. LLCs combined the limited liability of a corporation with the ability to avoid tax classification of a corporation because of lack of transferability, no centralized management, and lack of continuity of life. LLCs taxed as partnerships allowed flow through of tax losses and avoided the two layers of taxation experienced by corporate owners receiving dividends.

Despite these advantages, LLCs were not particularly interesting to tax planners until the Tax Reform Act of 1986

³² Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537.

³³ *Kintner v. United States*, 107 F. Supp. 976, 979 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954); Treas. Reg. § 301.7701-2(a)(1) (1960); see Heather M. Field, *Checking in on "Check-the-Box,"* 42 LOY. L.A. L. REV. 451, 459–60 (2009).

³⁴ Treas. Reg. § 301.7701-2(a)(1).

³⁵ See Treas. Reg. § 301.7701-2(a)(2)–(3).

³⁶ See *id.*

³⁷ Table derived from JEFFREY L. KWALL, *THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS* 6–7 (4th ed. 2012).

Years	Maximum Corporate Tax Rate	Maximum Individual Tax Rate
1954–1963	52%	91%
1964	50%	77%
1965–1978	48%	70%
1979–1980	46%	70%
1981–1986	46%	50%
1987	40%	38.5%
1988–1990	34%	28%
1991–1992	34%	31%
1993–2000	35%	39.6%
2001	35%	39.1%
2002	35%	38.6%
2003–2012	35%	35%
2013	35%	39.6%

reduced the top marginal tax rate applied to individuals to below the corporate tax rate.³⁸ The Congressional Budget Office found that the reduction in the top individual rate and neutrality between individual and corporate tax rates “probably stimulated the growth of pass-through entities.”³⁹ The interest in subchapter S peaked at about the same time.⁴⁰ Florida was the second state to enact LLC legislation in 1982,⁴¹ but no other states followed suit until after the IRS ruled on the tax classification of LLCs in 1988.⁴² In Revenue Ruling 88-76, the IRS ruled that entities formed under the Wyoming LLC statute would be classified as tax partnerships because they lacked the corporate characteristics of continuity of life and free transferability of interests.⁴³ By 1997, all fifty states had enacted LLC legislation.⁴⁴

1996 marked the most significant change in entity classification for tax purposes: the promulgation of the “check-the-box” (CTB) regulations.⁴⁵ Whereas under prior regulations, the IRS determined the tax classification of a business entity by examining its corporate characteristics, the CTB regulations allowed non-corporate entities to elect their tax classification. The regulations solved problems for both the IRS and taxpayers. The IRS no longer needed to use resources to litigate or issue guidance on entity classification issues.⁴⁶ Theoretically, taxpayers could save on tax advice regarding entity classification issues.⁴⁷ Under the CTB regulations, all domestic entities that are not incorporated under state law are eligible to elect to be taxed as corporations.⁴⁸ The CTB regulations also provide default rules for entities that do not make an explicit election: a domestic eligible entity is taxed under partnership tax rules if it has two or more owners and is disregarded for tax purposes if it has only one owner.⁴⁹ LLCs

³⁸ See Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 313 (Steven A. Bank & Kirk J. Stark eds., 2005) [hereinafter Hamill I] (“The rise of the LLC has been largely driven by tax considerations . . .”).

³⁹ CONG. BUDGET OFFICE, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX 13–14 (2012) [hereinafter CBO].

⁴⁰ *Id.* at 12–13 (“The number of S corporations rose by almost 37 percent between 1986 and 1987, the largest annual increase in such entities during the 1986-2007 period.”).

⁴¹ Florida Limited Liability Company Act, ch. 82-177, 1982 Fla. Laws 580.

⁴² Rev. Rul. 88-76, 1988-2 C.B. 360.

⁴³ *Id.*

⁴⁴ Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1470, 1473–77 (1998) [hereinafter Hamill II].

⁴⁵ Treas. Reg. § 301.7701-3 (1997).

⁴⁶ See Field, *supra* note 33, at 464.

⁴⁷ *Id.* However, as will be illustrated, the choice is still not all that simple.

⁴⁸ Treas. Reg. § 301.7701-3(a) (as amended in 2006).

⁴⁹ Treas. Reg. § 301.7701-3(b).

made up the majority of all partnerships (64.3%) in 2011.⁵⁰ The number of domestic general partnerships has declined 24.9% over the past ten years.⁵¹

The combination of the nationwide availability of the LLC entity form and the CTB regulations means that taxpayers can freely choose a business form that provides limited liability without the need for the formality of incorporation. The CTB regulations even allow taxpayers to choose S corporation taxation without incorporating under state law. The taxpayer need only form an LLC, then elect to be taxed as a corporation, then make another election to be taxed as an S corporation.⁵² Americans like choices, or at least we think we do.⁵³ But while the availability of these options makes the alternatives simpler to obtain, it does not make it simpler to make the right choice.⁵⁴ The next section will outline the differences between partnership and subchapter S taxation that taxpayers need to consider when choosing a business entity.

C. Comparison of Partnership and S Corporation Tax Provisions

I'm perfectly happy to say that anyone who puts in a structure that pays more tax than necessary is nuts.⁵⁵

Partnership tax provisions are flexible but complex to apply.⁵⁶ S corporation tax provisions are restrictive but simple to apply. Each has advantages and disadvantages in particular situations. The following paragraphs explore a dozen differences in the taxation of partnership and S corporations.

⁵⁰ Ron DeCarlo, Lauren Lee & Nina Shumofsky, *Partnership Returns, 2011*, STAT. INCOME BULL., 2013, at 5, 7 (2013).

⁵¹ *Id.* at 8.

⁵² Rev. Rul. 2009-15, 2009-21 I.R.B. 1.

⁵³ "The United States was founded on a commitment to individual freedom and autonomy, with freedom of choice as a core value." BARRY SCHWARTZ, *THE PARADOX OF CHOICE: WHY MORE IS LESS* 4 (2004). The book asked the question "Is [e]xpanded [e]hoice [g]ood or [b]ad?" and noted that choosing well is difficult, and that unlimited choice "can produce genuine suffering." *Id.* at 18, 47, 201.

⁵⁴ The premise of another excellent book, *Nudge*, is that people are not necessarily good at making choices and that governments can use "choice architecture" to improve people's chances of making the right decision. RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 11 (2008).

⁵⁵ Michael Moss & Kate Zernike, *The 2004 Campaign: The North Carolina Senator; Campaign Releases Edwards's Earnings*, N.Y. TIMES (July 10, 2004), <http://www.nytimes.com/2004/07/10/us/2004-campaign-north-carolina-senator-campaign-releases-edwards-s-earnings.html> (quoting Veranda Smith, a government affairs associate with the Federation of Tax Administrators).

⁵⁶ Indeed, some commentators consider the existing partnership tax regime to be completely dysfunctional. See Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 ALA. L. REV. 289, 291 (2012).

1. Maximum Number of Equity Interests

Entities taxed as partnerships have no limit on the number of equity holders, but certain publicly traded partnerships lose the benefits of subchapter K and are instead taxed under subchapter C.⁵⁷ S corporations can have a maximum of 100 shareholders, but members of a family, as defined, may be treated as a single shareholder.⁵⁸

2. Classes of Equity Interests

Entities taxed as partnerships have no limit on the types of equity interests—partners can be general, or limited, and can have special allocations for tax and distribution purposes, provided that tax allocations have substantial economic effect.⁵⁹ S corporations cannot have more than one class of stock, although voting rights may differ.⁶⁰ If the IRS finds that an S corporation has more than one class of stock, the corporation's S election is terminated.⁶¹ If a shareholder has made a loan to the corporation and the loan is treated as equity under general principles of tax law, the loan will constitute a second class of stock.⁶²

3. Eligible Owners

Entities taxed as partnerships may have foreign owners, tax-exempt owners, corporate owners, partnership owners, trusts as owners—there are no restrictions on what or who may own a partnership interest. S corporation ownership, in contrast, is limited to individuals, estates, certain trusts, and certain charities.⁶³ An S corporation cannot have a corporate shareholder or a foreign shareholder.⁶⁴

⁵⁷ I.R.C. § 7704 (2012). Publicly traded partnerships are unlikely to fall within the usual conception of “small business.” However, even publicly traded partnerships can avoid corporate taxation if 90% of the gross income for the year consists of “qualifying income,” which is defined in § 7704(d) as income from interest, dividends, real property rents, gain from the sale or other disposition of real property, or certain natural resources. *Id.*

⁵⁸ I.R.C. § 1361(b)(1)(A), as modified by § 1361(c)(1).

⁵⁹ I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(1)(i) (as amended 2013).

⁶⁰ I.R.C. § 1361(b)(1)(D), (c)(4).

⁶¹ *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200334017 (Aug. 22, 2003). The IRS, in its discretion, may waive the effect of the terminating event. I.R.C. § 1362(f).

⁶² Treas. Reg. § 1.1361-1(l)(4)(ii) (as amended 2008). The regulations also provide a safe harbor (under which the debt will not be treated as a second class of stock) for “straight debt,” defined as “a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date.” Treas. Reg. § 1.1361-1(l)(5). The debt must not provide for interest conditional on corporate profits, cannot be convertible into equity, and must be held by an individual. *Id.*

⁶³ I.R.C. § 1361(b)(1)(B), (c)(2), (c)(3), (c)(6) (2012).

⁶⁴ I.R.C. § 1361(b)(1)(C) (2012).

4. Allocation of Income and Losses

Both partnerships and S corporations are “flow-through” tax entities. Neither a partnership nor an S corporation is liable for federal income tax—rather, the owners bear the tax liability for the activities of the entity. The income and loss generated by a partnership flows through to the partners in accordance with the partnership agreement, provided that the allocations have “substantial economic effect.”⁶⁵ If the IRS determines that the allocations under the agreement fail the substantial economic effect test, the IRS will reallocate the items according to the partner’s interest in the partnership.⁶⁶ Thus, partnership allocations are flexible, but not certain.

S corporation income and loss are allocated to the shareholders on a rigid, per share, per day allocation system.⁶⁷ The income and loss are allocated pro rata unless a shareholder transfers all of her shares at a time other than the last day of the tax year. In that case, the shareholder who sells stock and the shareholder who buys the stock may make a “closing of the books” election, which would allocate a share of the income actually earned during the period of the year when the stock was owned by each shareholder.⁶⁸ A closing of the books election may also be made when a single shareholder disposes of 20% or more of the issued stock of an S corporation during any thirty day period⁶⁹ or when the S corporation issues an amount of stock equal to at least 25% of its previously outstanding stock to one or more new shareholders during any thirty day period.⁷⁰

5. Limitation on Losses

Both the partnership tax and S corporation rules limit the owner’s ability to deduct losses to the owner’s basis in entity.⁷¹ This rule necessarily fits with the overall flow-through taxation scheme. When income is allocated to an owner, the owner’s basis in the entity increases by the amount of the income.⁷² When losses or deductions are allocated to an owner, the owner’s basis in the entity decreases by the amount of the deduction.⁷³

⁶⁵ I.R.C. § 704(b).

⁶⁶ Treas. Reg. § 1.704-1(b)(1) (as amended 2013).

⁶⁷ I.R.C. §§ 1366(a), 1377.

⁶⁸ I.R.C. § 1377(a)(2).

⁶⁹ Treas. Reg. § 1.1368-1(g)(2)(i)(A) (as amended 2006).

⁷⁰ Treas. Reg. § 1.1368-1(g)(2)(iii).

⁷¹ For the partnership limitation on losses, see I.R.C. § 704(d). For the S corporation limitation on losses, see I.R.C. § 1366(d).

⁷² For partnership basis adjustments, see I.R.C. § 705(a)(1). For S corporation basis adjustments, see 26 I.R.C. § 1367(a)(1).

⁷³ I.R.C. §§ 705(a)(2), 1367(a)(2).

However, a partner's basis in the partnership is also increased by the partner's share of partnership debt.⁷⁴ An S corporation shareholder can deduct losses up to his basis in the S corporation and his basis in any loan he has made to the S corporation.⁷⁵ Courts have interpreted this provision narrowly.⁷⁶

6. Contributions of Property to the Entity

Both partners and S corporation shareholders can make tax-free contributions of appreciated property to the entity.⁷⁷ However, S corporation contributions only qualify as tax-free if the transferors, in the aggregate, have control of the corporation.⁷⁸ If a partner contributes property with a built-in gain or loss, when the partnership disposes of the property, the built-in gain or loss is allocated to the contributing partner, irrespective of any allocations in the partnership agreement.⁷⁹ S corporation gain is allocated on a per share, per day basis, irrespective of who contributed the asset.

7. Distributions of Property

When an S corporation distributes appreciated property to a shareholder, gain is recognized as if the S corporation sold the property.⁸⁰ The gain will flow through to the shareholders under the "per share, per day" allocation rule. While the general distribution rules for partnerships allow tax-free distribution of property,⁸¹ complex "anti-mixing-bowl" rules apply when property contributed by one partner is distributed to another,⁸² or when cash or other property is distributed to a contributing partner. For example, consider Partnership ABC in which Alice, Bridget, and Charlie each own 1/3 of the capital and profits interests. Alice contributes Asset 1 with a value of \$100 and a

⁷⁴ I.R.C. § 752. The partner's increase in basis happens because § 752 treats an increase in partnership debt as a contribution to the partnership. I.R.C. § 722 provides that a partner receives basis for contributions to the partnership. The rules for allocating debt among the partners can be intensely complex, particularly in the case of non-recourse debt. See Treas. Reg. § 1.752-2 (as amended 2006) for partner's share of recourse liabilities, and Treas. Reg. § 1.752-3 (2000) for partner's share of nonrecourse liabilities.

⁷⁵ I.R.C. § 1366(d)(1)(B).

⁷⁶ See *Estate of Leavitt v. Comm'r*, 875 F.2d 420 (4th Cir. 1989) (denying a deduction for S corporation debt guaranteed by the shareholder).

⁷⁷ For partnerships, see I.R.C. § 721(a) (2012). For S corporations, see I.R.C. § 351(a).

⁷⁸ I.R.C. § 351(a). Control is defined in I.R.C. § 368(c) as 80% of all classes of stock entitled to vote plus 80% of all other classes of stock.

⁷⁹ I.R.C. § 704(c)(1). For example, if a partner contributes property with a basis of \$20 and a fair market value of \$100, if the partnership later sells the property for \$150, \$80 of the \$130 gain will be allocated to the partner, in addition to any gain allocated under the partnership agreement.

⁸⁰ I.R.C. §§ 1371(c)(1), 311(b)(1).

⁸¹ See I.R.C. §§ 731-733.

⁸² I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 737.

basis of \$20. Bridget contributes \$100. Charlie contributes Asset 2 with a value of \$100 and a basis of \$60. If Bridget receives a distribution of Asset 1 in exchange for her partnership interest, Bridget recognizes neither gain nor loss and will take Asset 1 at a \$100 basis.⁸³ Alice, however, will recognize \$80 of gain.⁸⁴ If, in the alternative, Charlie receives a \$50 distribution from Partnership ABC within two years of contributing Asset 2, Charlie will recognize \$20 of gain,⁸⁵ even though under the usual rules of section 731, he would not recognize gain because the distribution is less than his basis in the partnership interest.

8. Transfer of Equity Interests

One of the most complex aspects of partnership taxation is the treatment of “hot assets.” When a partner sells a partnership interest (or in some cases, when the partner receives a distribution of partnership property), a portion of the gain recognized may be treated as ordinary income to the extent the property within the partnership is either unrealized receivables or substantially appreciated inventory.⁸⁶ Partnership tax also provides an election to adjust the “inside” basis of partnership assets when a new partner joins the partnership.⁸⁷ The section 754 election has the effect of reducing gain allocated to new partners upon the sale of existing partnership assets, as well as increasing depreciation deductions allocated to new partners with respect to existing partnership assets.

None of the foregoing applies to S corporations. Sales of S corporation stock or distribution of assets to S corporation shareholders do not affect the remaining assets in the S corporation. Sales of S corporation stock generally produce capital gain.⁸⁸ Distributions from S corporations are not taxed to the extent the distribution represents previously taxed income.⁸⁹ If the S corporation had previously operated as a C corporation, the rules are a bit more complex.⁹⁰

⁸³ I.R.C. §§ 731(a)(1), 732(b).

⁸⁴ I.R.C. § 704(c)(1)(B).

⁸⁵ I.R.C. § 707(a)(2)(B); Treas. Reg. § 1.707-3 (1992).

⁸⁶ I.R.C. § 751 (2012). For example, an unpaid bill owed to a doctor by a patient is an unrealized receivable. § 751(c). Substantially appreciated inventory, for example, could be Nerf Blasters with a \$45 value in a toy store that had paid \$30 for each Nerf Blaster. § 751(b)(3) (fair market value exceeds 120% of the basis).

⁸⁷ I.R.C. § 754.

⁸⁸ I.R.C. § 1221; *see* Ark. Best Corp. v. Comm’r, 485 U.S. 212, 223 (1988).

⁸⁹ I.R.C. § 1368(b).

⁹⁰ I.R.C. § 1368(c).

9. Transfer of Interest as Compensation for Services

As noted in paragraph seven above, owners of partnerships or corporations may transfer property in exchange for ownership interests without immediate tax consequences. However, services are not considered property.⁹¹ If an S corporation shareholder provides services in exchange for S corporation stock, the shareholder will have ordinary income in the amount of the value of the stock.⁹² The same is true for the receipt of a capital interest in a partnership.⁹³ But a partner may receive a profits interest in a partnership without immediate income recognition—because the profits interest is treated as having zero value.⁹⁴ A capital interest in a partnership gives the holder a share of the proceeds of the assets of the partnership if the partnership were to be liquidated.⁹⁵ A profits interest entitles the holder to a share of the profits of the partnership, if any.⁹⁶ This feature of partnership taxation is an essential part of the compensation of hedge fund and private equity managers.⁹⁷ The manager receives a profits interest in the fund as compensation for services. As the profits of the fund are mostly capital gains, the income is taxed at capital gains rates rather than as ordinary income.⁹⁸

10. Application of Employment Taxes

Partners must pay self-employment taxes on their share of net business income and guaranteed payments.⁹⁹ S corporation shareholder-employees receive wages, are not subject to self-employment taxes, and avoid employment taxes altogether on non-wage distributions.¹⁰⁰ The employment tax on an employee's wages (FICA)¹⁰¹ and the self-employment tax on net earnings from self-employment (SECA)¹⁰² are imposed at the same rate and with the same earnings cap, but with the liability

⁹¹ I.R.C. § 351(d).

⁹² I.R.C. § 83(a) (2012). If the stock is subject to transfer restrictions or substantial risk of forfeiture, then the timing of the income will be delayed until the restrictions or risk of forfeiture lapse, unless the shareholder makes an election to immediately include the value of the stock in gross income.

⁹³ Treas. Reg. § 1.721-1(b)(1) (as amended 2011).

⁹⁴ Rev. Proc. 93-27, 1993-2 C.B. 343.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ See Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT'L TAX J. 445, 445 (2008).

⁹⁸ See Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers'*, 138 TAX NOTES 361, 362 (2013).

⁹⁹ Cherie J. Hennig, Blaise M. Sonnier, William A. Raabe & John O. Everett, *S Corp Taxation: Level the Playing Field*, 139 TAX NOTES 435, 436 (2013).

¹⁰⁰ *Id.*; see also Willard B. Taylor, *Payroll Taxes—Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983, 987 (2012).

¹⁰¹ I.R.C. § 3101 (2012).

¹⁰² I.R.C. § 1401.

for FICA divided equally between the employer and the employee.¹⁰³ FICA is imposed on all wages received as remuneration for employment, while SECA is imposed on net earnings from a trade or business. The employment tax advantage of S corporations has been enjoyed by some prominent persons,¹⁰⁴ leading others to call it a “loophole.”¹⁰⁵ To achieve this loophole, the S corporation shareholder-employee would seek to minimize the amount received as “compensation.”¹⁰⁶

11. Real Estate Transactions

Property owners may hold property for investment and later decide to develop the property. To minimize tax liability, property owners seek to separate the investment function from the development function to recognize as long-term capital gain any portion of the gain attributable to the period for which they held the property for investment.¹⁰⁷ To accomplish this goal, the property is initially held in an investment entity, which then transfers the property to a development entity.¹⁰⁸ If the two entities have significant overlap in ownership, the development entity needs to be a corporation (including an S corporation) for the strategy to succeed. Partnership rules treat the gain on the transfer of property between related partnerships as ordinary income if the property would not be a capital asset in the hands of the transferee.¹⁰⁹

The foregoing clearly shows that there are differences between the taxation of LLCs and S corporations. However, it does not illustrate which type of entity would be best for small businesses. Assuming that Congress and policymakers will continue to support small business, that consideration should be paramount when assessing the effectiveness of tax reform. If S

¹⁰³ See STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF THE SOCIAL SECURITY TAX BASE (2011).

¹⁰⁴ Former presidential candidates John Edwards and Newt Gingrich employed the S corporation strategy. Moss & Zernike, *supra* note 55 (Edwards); Paul Sullivan, *The Advantages and Risks of Gingrich's Tax Strategy*, N.Y. TIMES (Feb. 3, 2012), <http://www.nytimes.com/2012/02/04/your-money/advantages-and-risks-of-gingrichs-s-corporation.html> (Gingrich).

¹⁰⁵ See Stephen R. Looney, *Finding Loopholes in Closing S Corp Loopholes*, 141 TAX NOTES 895, 895 (2013).

¹⁰⁶ *Id.*; see, e.g., *Watson v. United States*, 668 F.3d 1008, 1017 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010); see also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009). In the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly \$23.6 billion, which could result in around \$3 billion in total employment tax underpayments.

¹⁰⁷ I.R.C. § 1221(a)(1). Capital asset does not include “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” *Id.*

¹⁰⁸ See *Bramblett v. Comm'r*, 960 F.2d 526, 534 n.2 (5th Cir. 1992).

¹⁰⁹ I.R.C. § 707(b)(2).

corporations are better for the type of small business that policymakers want to support, then Congress should not repeal subchapter S. The next section will review the arguments for and against retaining subchapter S.

II. ARGUMENTS FOR AND AGAINST RETAINING SUBCHAPTER S

S corporations have had detractors and defenders since before LLCs became popular.¹¹⁰ The rhetoric heated up considerably after the promulgation of the CTB regulations. In 1999, the prestigious American Law Institute issued a study on the taxation of private business enterprise, which advised requiring most non-publicly held business entities to be taxed under a modified partnership tax system.¹¹¹ While not specifically critical of subchapter S, Professor George Yin, one of the co-authors of the ALI study, explained that “[t]he elective tax treatment [of private firms under current law] undermines both equity and efficiency objectives for the income tax.”¹¹² Yin explained that the ALI study did not use subchapter S as a model for conduit taxation “because of its entity tax features which seemed inconsistent with a conduit tax objective.”¹¹³ Yin praised subchapter S as “a remarkably coherent version of a simplified conduit system.”¹¹⁴

Other commentators were not so flattering. In 1996, Professor Walter Schwidetzky argued that the ready availability of LLCs meant that subchapter S was “ready for retirement.”¹¹⁵ He opined, “An LLC has all the advantages of a partnership, and the potential simplicity of an S corporation. There is little about a

¹¹⁰ Compare Warren P. Kean, Comment, *After the Facelift, Is Subchapter S Any More Attractive?*, 46 LA. L. REV. 87, 131 (1985) (“The non-tax privileges of operating in the corporate form, as bridled by the restrictions in subchapter S, will in many instances be an insufficient counterpoise to warrant the small business corporation election.”), with Ronald Freeman, *The Subchapter S Corporation Distributive System After the Subchapter S Revision Act*, 62 TAXES 773, 787 (1984) (“Both taxpayers and their tax advisors should welcome these changes to the intricate Subchapter S system.”).

¹¹¹ See George K. Yin, *The ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 85 TAX NOTES 91, 91 (1999).

¹¹² George K. Yin & David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises*, in STAFF OF THE JOINT COMM. ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 at 220, 222 (2001).

¹¹³ George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 172 (1999).

¹¹⁴ *Id.* at 173. Professor Phillip Postlewaite argued that the ALI study, while paying lip service to using subchapter K as a model, in fact created a modified subchapter S. Phillip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 456 (2001).

¹¹⁵ See Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 642 (1996).

plain vanilla LLC that makes it less foolproof than a plain vanilla S corporation.”¹¹⁶ Schwidetzky did not define a “plain vanilla LLC.” It may be that he was contemplating an entity without special tax allocations.¹¹⁷ However, even without special tax allocations, the Mom and Pop owners of the “plain vanilla LLC” would still be subject to the complex “anti-mixing bowl” provisions of Subchapter K, as well as the “hot asset” rules and the issue of how to determine allocations of basis with respect to LLC recourse and non-recourse debt.¹¹⁸ Thirteen years later, with subchapter S still stubbornly hanging on, Schwidetzky again urged Congress to pull the plug.¹¹⁹

Professor Jeffrey Maine, on the other hand, has been a staunch defender of subchapter S.¹²⁰ Maine agrees with Schwidetzky that the taxation of pass-through entities should be consolidated, but Maine prefers a single pass-through regime based on subchapter S rather than subchapter K.¹²¹ With respect to the ALI study’s choice of partnership tax as a model, Maine considers the study’s rejection of the S corporation model as a misreading of the theory of corporate taxation.¹²² Examining the history of the corporate tax, Maine concludes that the taxation of corporations as entities developed because of the statutory benefit of limited liability, rather than the conception of the corporation as a “natural entity.”¹²³ The incorrect adoption of an entity theory of taxation, in Maine’s view, doomed tax classification based on form and led inevitably to the CTB regulations.¹²⁴ Maine asked, “If federal tax law views a corporation as independent of its shareholders, then why does federal tax law abandon the entity view with respect to both the formation of all corporations via § 351 and the operation of more

¹¹⁶ *Id.* at 637.

¹¹⁷ This seems likely from Schwidetzky’s later article. See Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749, 768 (2009) (footnote omitted) (“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. Further, in these closely held entities, the complexities of Subchapter K are mostly held in abeyance, so that the LLC is also a fairly simple entity for tax purposes.”).

¹¹⁸ Schwidetzky, *supra* note 117, at 810.

¹¹⁹ *Id.* at 813.

¹²⁰ See Jeffrey A. Maine, *Evaluating Subchapter S in a “Check-the-Box” World*, 51 TAX LAW. 717, 763 (1998) (arguing on both practical and theoretical grounds that subchapter S has continuing utility in a check-the-box environment).

¹²¹ See Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 62 PITT. TAX REV. 223, 271 (2000).

¹²² *Id.* at 243.

¹²³ *Id.* at 244.

¹²⁴ *Id.* at 244–46.

than half of all corporations via Subchapter S?”¹²⁵ Maine advocates for entity taxation based on limited liability, rather than form.¹²⁶

While the scholars debate whether Subchapter K or Subchapter S is the best model of small business taxation, taxpayers and practitioners continue to choose the form that best suits the business model.¹²⁷ Clearly, S corporations continue to be a popular business entity. S corporations are the second most popular choice for businesses, after sole proprietorships.¹²⁸ In 2009, S corporation tax returns comprised more than 70% of all corporate tax returns.¹²⁹ There were almost a million more S corporation tax returns than partnership tax returns.¹³⁰ Moreover, S corporations are still popular with small businesses. In 2008, S corporations with less than \$100,000 in assets filed roughly 60% of the over 4 million total S corporation returns filed.¹³¹

Is it appropriate to eliminate taxpayers' choice of pass-through regime? Does having a single pass-through tax regime really make it easier for taxpayers and practitioners? It is axiomatic that tax reform should produce results that improve economic efficiency, fairness, and administrability.¹³² But these considerations can be viewed from a variety of perspectives. Any time a choice is available, resources must be used in determining which choice to make. Field notes that “when an election is available, there are necessarily multiple possible tax outcomes, and thus taxpayers must analyze (and often incur the costs to obtain advice regarding) which alternative is preferable.”¹³³ Schwidetzky agrees, stating that “[h]aving two pass-through regimes is inefficient.”¹³⁴ On the other hand, it may be more economically efficient for a particular business to operate in one or other taxing regimes; thus, losing the ability to choose may be inefficient from the perspective of the taxpayer. Schwidetzky further argues that having two pass-through regimes is unfair to taxpayers, because wealthy taxpayers are more likely to be

¹²⁵ *Id.* at 248.

¹²⁶ *Id.* at 271.

¹²⁷ See Stewart Karlinsky, *S Corporations: Let Me Count the Ways*, 134 TAX NOTES 335 (2012).

¹²⁸ JCT, *supra* note 23, at 3.

¹²⁹ *Id.* at 5.

¹³⁰ *Id.*

¹³¹ *Id.* at 5, 7–8.

¹³² See, e.g., Roberta Mann, *Waiting to Exhale?: Global Warming and Tax Policy*, 51 AM. U. L. REV. 1135, 1206 (2002) (“Classic evaluation of tax provisions involves consideration of equity, economic efficiency, and ease of administration.”).

¹³³ Field, *supra* note 33, at 474–75.

¹³⁴ See Schwidetzky, *supra* note 117, at 811.

well-advised and thus obtain the best tax results from their choice of entity.¹³⁵ Taking that advice to an extreme, a head tax would be the most fair tax of them all, because well-advised taxpayers would have no advantage. Yet few tax scholars would advocate for a head tax on fairness grounds.¹³⁶ Administrability could be viewed from the perspective of the government who needs to enforce the tax system or from the standpoint of the taxpayer who needs to comply with the system. The government may prefer to have a single pass-through tax regime, thereby saving resources in training, compliance, and enforcement efforts. On the other hand, taxpayers will weigh the savings in compliance costs against the loss of the ability to choose the best entity for their business, a choice that could save much more over the long term.

The government has identified compliance issues with both S corporations and partnerships. The Government Accountability Office (GAO) issued a report in 2009 outlining S corporation compliance issues.¹³⁷ S corporation shareholders understated income, overstated deductions, overstated basis, and understated shareholder-employee compensation.¹³⁸ The last issue resulted in \$23.6 billion in net underpaid wage compensation to shareholders for the 2003 and 2004 tax years.¹³⁹ S corporations have the ability to characterize business profits as either salary or shareholder flow-through income, allowing shareholder employees to “minimize their employment tax obligations by paying themselves low salaries.”¹⁴⁰ This so-called S corporation loophole made the hit list of tax targets for elimination in 2013.¹⁴¹ Reducing shareholder-employee compensation to avoid employment taxes has become even more popular since the 2010 health care reform law both increased the Medicare payroll tax and exempted S corporation business income from the tax.¹⁴² The

¹³⁵ *Id.*

¹³⁶ On efficiency grounds, yes.

¹³⁷ See GAO, *supra* note 106.

¹³⁸ *Id.* at 12.

¹³⁹ *Id.* at 25; see also TREAS. INSPECTOR GEN. FOR TAX ADMIN., REFERENCE NO. 2005-30-080, ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS 1-3 (2005).

¹⁴⁰ See Hennig et al., *supra* note 99, at 436; see also Richard Winchester, *Working for Free: It Ought to Be Against the (Tax) Law*, 76 MISS. L. J. 227, 227-28 (2006).

¹⁴¹ See Lindsey McPherson, *Democrats List Tax Targets for Elimination in Budget Talks*, 141 TAX NOTES 591 (2013).

¹⁴² *Id.*; I.R.C. § 1411; see Looney, *supra* note 105, at 895.

The critics of the purported S corporation loophole have generally focused on the fact that non-wage distributions from ‘personal service S corporations’ may be one of the few paths to receive income untouched

proposal was estimated to raise between \$10 billion and \$15 billion in increased tax revenue over ten years.¹⁴³ However, the budget compromise approved at the end of 2013 contained no tax provisions at all, so it is uncertain when, if ever, this proposal will become law.¹⁴⁴

Partnership tax compliance issues, on the other hand, are so vast and varied that this Article could not even begin to scratch the surface.¹⁴⁵ The peculiar flexibility of the partnership tax system, allowing flexible allocations of deductions, tax indifferent partners, allocations of deductions, and loss based on non-recourse debt, makes partnerships an essential part of many corporate tax shelters.¹⁴⁶ As Professor Lawrence Lokken wrote, “partnership allocations can be used to divorce tax consequences from economic consequences.”¹⁴⁷

III. CHAIRMAN CAMP’S SMALL BUSINESS TAX REFORM: IN CONTEXT

Chairman Camp’s small business tax reform discussion draft contains two options: Option 1 retains Subchapter S and Subchapter K, with tweaks. Option 2 replaces Subchapter S and Subchapter K with a unified pass-through regime.¹⁴⁸ Focusing on the more radical Option 2, I will summarize the provisions to facilitate the following discussion about why Congress wants to support small business and what type of small business Congress wants to support. Then we will be prepared to consider how best to meet those goals.

from the FICA tax, the self-employment tax, and on the new net investment income tax imposed under section 1411.

Id. at 896.

¹⁴³ McPherson, *supra* note 141, at 591.

¹⁴⁴ Marcella S. Kreiter, *The Issue: Budget Deal Moves to Senate; New Era of Compromise?*, UPI (Dec. 15, 2013, 4:30 AM), http://www.upi.com/Top_News/US/2013/12/15/The-Issue-Budget-deal-moves-to-Senate-new-era-of-compromise/UPI-31291387099800/.

¹⁴⁵ See Monroe, *supra* note 56, at 291–94; see generally Postlewaite, *supra* note 114.

¹⁴⁶ See, e.g., *ACM P’ship v. Comm’r*, 157 F.3d 231, 247–50 (3d Cir. 1998). See generally STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS (Comm. Print 1999).

¹⁴⁷ Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 264 (1999). The codification of the economic substance doctrine in 2010, as well as the regulatory partnership anti-abuse rule, have somewhat restricted the use of partnerships in tax shelters. I.R.C. § 7701(o); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067–68; Treas. Reg. § 1.701-2 (1995); see also Monte A. Jackel, *Tax-Motivated Transactions: The Black, the White, the Gray*, 139 TAX NOTES 449, 450–51 (2013) (discussing recent tax shelter cases).

¹⁴⁸ See WAYS & MEANS DISCUSSION DRAFT, *supra* note 3.

A. Option 2

The unified pass-through tax regime of Option 2 would apply to any partnership and any eligible corporation that elects to be treated as a pass-through entity.¹⁴⁹ Any corporation is eligible to make the election except for those which are (1) publicly traded, (2) a financial institution that uses the reserve method of accounting for bad debts, (3) an insurance company subject to tax under Subchapter L, or (4) a domestic international sales corporation (DISC) or former DISC.¹⁵⁰ The technical explanation follows this description with this statement: “Thus, a pass-through corporation does not include . . . ineligible corporations under present law subchapter S.”¹⁵¹ However, the current law’s definition of an eligible S corporation also provides that the corporation must be domestic.¹⁵² Under Option 2 as drafted, a foreign corporation could elect pass-through treatment.¹⁵³ Option 2 also requires that entity to withhold taxes from the owner’s distributive share of pass-through income.¹⁵⁴ The remainder of the analysis of Option 2 will attempt to follow the categories used in the prior discussion of the differences between Subchapter K and Subchapter S.

1. Maximum Number of Equity Interests

Option 2 does not limit the number of owners. Present law Subchapter S limits the number of shareholders to 100. Present law Subchapter K allows partnerships with over 100 partners to use a modified allocation system if the partnership makes an election.¹⁵⁵

2. Classes of Equity Interests

Like Subchapter K, Option 2 does not limit the number of classes of entity interests. Present law Subchapter S allows only one class of equity interest.

3. Eligible Owners

Like Subchapter K, Option 2 does not limit the eligible owners. For example, an eligible pass-through entity could have

¹⁴⁹ TECHNICAL EXPLANATION, *supra* note 3, at 42–43.

¹⁵⁰ *Id.* at 43. Present law treats certain publicly traded partnerships as corporations, disallowing pass-through taxation. I.R.C. § 7704 (2012).

¹⁵¹ TECHNICAL EXPLANATION, *supra* note 3, at 43.

¹⁵² I.R.C. § 1361(b)(1).

¹⁵³ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 703; TECHNICAL EXPLANATION, *supra* note 3, at 43.

¹⁵⁴ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 701; TECHNICAL EXPLANATION, *supra* note 3, at 42.

¹⁵⁵ I.R.C. §§ 771–776.

a publicly traded corporation or a non-resident alien¹⁵⁶ as an owner.

4. Allocation of Income and Losses

Here, Option 2 differs from both present law Subchapter K and Subchapter S. Under Option 2, the owner's distributive share of income and losses must be consistent with the owner's economic interest in the pass-through entity.¹⁵⁷ This appears to be an attempt to simplify the substantial economic effect test under section 704(b) and the voluminous regulations thereunder. As the draft specifies that the owner's economic interest is to be determined by all the facts and circumstances, it is unclear how much simplification this rule would provide.¹⁵⁸ The ownership agreement may not provide different distributive shares of pass-through items within a particular category to the same owner. The categories are (1) ordinary items, (2) capital gain rate items, and (3) tax credits. It is unclear whether this rule is intended to apply during the entire time the owner has an equity interest or year by year.¹⁵⁹ The draft directs the Treasury to write regulations preventing avoidance of this restriction, another potential source of intense complexity.

5. Limitation on Losses

Like present law Subchapter K and S, Option 2 limits the owner's ability to use pass-through losses to the owner's basis in the entity.¹⁶⁰ The owner's basis in the entity is determined in a manner similar to Subchapter K and Subchapter C.¹⁶¹ The draft is silent on how entity level debt is included in the owner's basis, but it appears to import principles similar to those in Subchapter K.¹⁶²

¹⁵⁶ Under present law, S corporations need not worry about section 1441 source withholding, as they may not have foreign owners.

¹⁵⁷ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 712; TECHNICAL EXPLANATION, *supra* note 3, at 45.

¹⁵⁸ "[I]n light of the uncertainties in applying the partners' interest in the partnership rule under current law, what makes the drafters of Camp's proposals think the concept of economic interests will be simple for small businesses to apply?" Jackel, *supra* note 4, at 1366.

¹⁵⁹ See Taylor, *supra* note 4, at 1054.

¹⁶⁰ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 712(e).

¹⁶¹ *Id.* § 713.

¹⁶² *Id.* § 752. See Jackel, *supra* note 4, at 1364 ("The discussion draft would extend to passthrough corporations the principles of section 752 regarding the allocating of debt to and from partnership and partners. However, the proposal does not explain how the shares of the entity's debt are allocated to the owners under the Option 2 system.").

2014]

Subchapter S: Vive le Difference!

85

6. Contributions of Property to the Entity

Option 2 allows tax-free contributions of appreciated property to the pass-through entity, like Subchapter K, and does not include a control requirement, like Subchapter S.¹⁶³

7. Distributions of Property

Option 2 adopts a Subchapter S approach with respect to the distribution of property to an owner of the entity. Like Subchapter S, Option 2 requires the recognition of gain in the amount of the difference between the entity's basis in the property and the fair market value of the property.¹⁶⁴ The owner will not recognize gain or loss (other than the owner's distributive share of the gain recognized in the previous sentence) if the owner's basis in the entity is more than the fair market value of the distribution. However, like Subchapter K, pre-contribution gain or loss will be allocated to the contributing owner. This rule seems to adopt the worst of both of Subchapter S and K. Like Subchapter S (and Subchapter C), appreciated assets can go in tax-free, but face a tax when removed from the entity. Like Subchapter K, owners must keep track of pre-contribution gain and face "mixing bowl" rules.

8. Transfer of Equity Interests

The draft adopts the Subchapter K rules on termination of a pass-through entity, which provide that the passthrough is terminated if the entity's operations cease, or if within a 12-month period there is an aggregate sale or exchange of at least 50% of the pass-through interests. Pass-through interests are generally treated as capital assets, but look-through rules similar to the "hot asset" rules of Subchapter K apply.¹⁶⁵

9. Transfer of Interest as Compensation for Services

The draft does not address this issue. Several commentators thought that the draft contemplated the continued availability of profits interests.¹⁶⁶

10. Application of Employment Taxes

The draft does not address this issue.¹⁶⁷

¹⁶³ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 721(a).

¹⁶⁴ See I.R.C. § 311(b)(1) (2012); *see also* I.R.C. § 1371(a).

¹⁶⁵ See Yin, *supra* note 4, at 361 (explaining that "[t]he discussion draft appears to retain the substance of § 751(b)" and "Section 751(b) is an extremely complicated provision" with a compliance rate of 2.5%); TECHNICAL EXPLANATION, *supra* note 3, at 55; I.R.C. § 751(b)(3).

¹⁶⁶ Jackel, *supra* note 4, at 1365; Taylor, *supra* note 4, at 1057.

11. Real Estate Transactions

Option 2 adopts the Subchapter K rule treating the gain on the transfer of property between related partnerships as ordinary income if the property would not be a capital asset in the hands of the transferee.

Option 2 does not cover all possible issues relating to pass-through entity taxation, which is unsurprising, as it is meant to be a starting point for discussion.¹⁶⁸ Commentators generally viewed the draft as a good start, but clearly there are many unresolved issues.¹⁶⁹ Practitioner Willard B. Taylor found that “[t]he great merit of option 2 is that in positing the elimination of subchapter S, it requires us to focus on whether the differences between subchapters S and K make any sense and on whether there are simpler ways to treat passthroughs than those in existing subchapter K.”¹⁷⁰ Professor George Yin has questioned whether the concept of a single tax system for pass-through entities makes sense. He noted,

Uniformity places considerable pressure on the specific rules selected and if there are broad differences in the taxpayers subject to the single set of rules, there is significant risk that the uniform system will produce an “unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.”¹⁷¹

Yin argued that taxpayers should be able to choose to surrender “some economic flexibility in exchange for a simpler set of tax rules and reduced compliance costs.”¹⁷² While advocating for two tax systems for passthroughs, Yin advised that current law should be modified to limit differences between the two systems to those that relate to simplification and compliance.¹⁷³ Yin’s suggestions seem practical and consistent with the classic goals of tax reform. Moreover, even though Yin suggested eliminating

¹⁶⁷ See Taylor, *supra* note 4, at 1057.

¹⁶⁸ Press Release, House Comm. On Ways & Means, Strengthening the Economy and Increasing Wages by Making the Tax Code Simpler and Fairer for America’s Small Businesses (Mar. 12, 2013), available at http://waysandmeans.house.gov/news/document_single.aspx?DocumentID=323445 (“Camp urged stakeholders to review and comment on the discussion draft and to share feedback with their lawmakers . . .”).

¹⁶⁹ See, e.g., Jackel, *supra* note 4, at 1363 (“[T]he draft provides a good starting point for the tax reform debate.”).

¹⁷⁰ Taylor, *supra* note 4, at 1058.

¹⁷¹ George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358, 359 (2013) (quoting GEORGE K. YIN & DAVID J. SHAKOW, TAXATION OF PRIVATE BUSINESS ENTERPRISES 115 (1999)).

¹⁷² *Id.*

¹⁷³ *Id.*

differences that solely create tax advantages, practitioners would likely approve of the trade-off.¹⁷⁴

Practitioner Stewart Karlinsky has observed that “[b]ecause the administrative burden and complexity of the tax system disproportionately affect small business, the ability to choose a simpler business entity form is an important nontax advantage.”¹⁷⁵ He cited two important simplification advantages of S corporations: the required per share, per day allocation rule for income and losses and the lack of built-in gain and loss rules which apply in partnership tax, which complicate the tracking of which assets are sold and to whom the gain or loss should be allocated.¹⁷⁶ Yin suggested the change that Karlinsky viewed as most significant for simplification: inclusion of entity level debt in owner’s basis.¹⁷⁷ Yin has also suggested eliminating differences in employment tax consequences and in the taxation of distributions.¹⁷⁸

B. Why the Focus on Small Business?

You wanna go where people know, people are all the same, you wanna go where everybody knows your name.¹⁷⁹

Chairman Camp’s discussion draft press release puts small business squarely in the picture. The purpose of the proposal is stated as “to help strengthen the economy by helping *small business* expand operations . . . and increase wages and benefits.”¹⁸⁰ The press release quoted Camp: “More Americans get their paycheck from *small businesses* than any other type of business or government. If we really want to strengthen our economy and put more money in the pockets of American workers, we must fix the tax code and how it treats *small businesses*” and “[t]he tax code ought to be easier to understand and less expensive for *small businesses* to comply with That is my goal for comprehensive tax reform – a simpler, fairer tax code that leads to more jobs and higher wages.”¹⁸¹ The two-page press release uses the term “small business” fifteen times.¹⁸²

¹⁷⁴ *Id.*

¹⁷⁵ Karlinsky, *supra* note 127, at 356.

¹⁷⁶ *Id.*

¹⁷⁷ Yin, *supra* note 4, at 359; Karlinsky, *supra* note 127, at 357.

¹⁷⁸ Yin, *supra* note 4, at 359.

¹⁷⁹ GARY PORTNOY & JUDY HART ANGELO, WHERE EVERYBODY KNOWS YOUR NAME (Argentum Records 1982) (theme song from the television show *Cheers*). *Cheers* ran from 1982 to 1993 on NBC. *Cheers*, IMDB, <http://imdb.com/title/tt008399/> (last visited Feb. 24, 2014).

¹⁸⁰ Press Release, House Comm. On Ways & Means, *supra* note 168 (emphasis added).

¹⁸¹ *Id.* (emphasis added).

¹⁸² *Id.*

The virtue of small businesses is a deeply held cultural belief. Professor Mirit Eyal-Cohen drew this picture: “We patronize them daily; they are builders, mechanics, and retail stores. They are the local laundry, the neighborhood hairdresser, and the corner bakery.”¹⁸³ Small is beautiful, and big is scary.¹⁸⁴ In the view of Congress, “small business is the engine which drives our economy.”¹⁸⁵ Still, the love expressed by Congress for small business fails to define small business. What does Chairman Camp mean by “small business”? Martin Sullivan has noted, with support from the Treasury, that “[i]t is common practice for politicians and the press to use the term ‘small business’ to describe pass-through businesses.”¹⁸⁶

While it is true that most small businesses enjoy pass-through tax treatment,¹⁸⁷ it is not true that all pass-through entities are small businesses. The Office of Tax Analysis (OTA) of the Treasury Department found that 18% of partners own firms that are not small—defined as having gross receipts in excess of \$10 million.¹⁸⁸ Six percent of S corporation shareholders own shares in large businesses.¹⁸⁹ Using passthrough as a proxy for small business is hopelessly circular. Pass-through tax treatment has been justified as helping small business.¹⁹⁰ But if businesses that are eligible to receive pass-through tax treatment are per se small, “small” has no meaning.

Having logically eliminated eligibility for pass-through tax treatment as an appropriate definition for small business, the next question is what type of small businesses does Congress want to support. The Camp press release appears to equate small businesses with jobs.¹⁹¹ “[T]he unchallenged conventional economic wisdom is that small businesses are the source of most

¹⁸³ Eyal-Cohen I, *supra* note 7, at 6. You can almost hear the theme song from the long-running television series *Cheers*.

¹⁸⁴ Richard J. Pierce, Jr., *Small is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms*, 50 ADMIN. L. REV. 537, 538 (1998) (noting that the myth that small is good and big is bad is deeply rooted in our cultural beliefs).

¹⁸⁵ *The President's Tax Proposals To The Congress For Fairness, Growth, and Simplicity: Hearings Before the H. Comm. On Ways & Means*, 99th Cong. 2742 (1985) (statement of Hon. James Sasser, Sen.).

¹⁸⁶ See Sullivan, *supra* note 25, at 1085.; see also Knittel, *supra* note 30, at 2.

¹⁸⁷ JCT, *supra* note 23, at 5, 7–8. In 2008, 60% of S corporations had less than \$100,000 in assets and almost half of partnerships had less than \$100,000 in assets. *Id.* at 5.

¹⁸⁸ Knittel et al., *supra* note 30, at 17.

¹⁸⁹ *Id.*

¹⁹⁰ Small businesses have trouble accessing capital, therefore they must be relieved from the burden of double taxation. See Eyal-Cohen I, *supra* note 7, at 21 (“Taxes reduced their main source of financing, because small businesses did not enjoy easy credit and remained unable to fill their needs for growth and expansion through borrowing.”).

¹⁹¹ See Press Release, House Comm. On Ways & Means, *supra* note 168.

job creation.”¹⁹² However, it is also untrue that most small businesses are job creators. When the data is controlled for the age of the business, it becomes clear that new businesses create jobs, not small businesses.¹⁹³ The researchers have concluded that “policies targeting firms based on size without taking account of the role firm age [plays] are unlikely to have the desired impact on overall job creation.”¹⁹⁴ Another study found that most small businesses, defined as firms with fewer than twenty employees, do not grow significantly, but rather start small and stay small.¹⁹⁵ Small businesses are mainly lawyers, doctors, real estate agents, shopkeepers, restaurants, and skilled craftspeople. Not only do these businesses not grow, they don’t want to grow.¹⁹⁶ Only a small fraction of businesses are started by founders who have a new idea, but those innovative businesses do seek expansion and create jobs.¹⁹⁷ The study found that businesses that seek venture capital are more likely to grow than other small firms.¹⁹⁸ These studies suggest a path forward for policymakers seeking to encourage job creation.¹⁹⁹ Rather than subsidize small business, Congress could focus its efforts on entrepreneurial business.²⁰⁰ But that advice is well beyond the scope of this Article, which seeks to determine whether Subchapter S should survive.

CONCLUSION

Perhaps Congress is wrong about small businesses being job creators and it should not seek to use scarce resources to help them. Nonetheless, Congress seems to want to help small businesses. Does Subchapter S help small businesses? Sullivan wrote, “If Congress really wants to help all small businesses, its best course of action would be to reduce compliance costs.”²⁰¹ Karlinsky argued, “[T]he simplicity of a small business doing

¹⁹² Martin A. Sullivan, *New Research Weakens Case for Small Business Tax Relief*, 134 TAX NOTES 54 (2012).

¹⁹³ John C. Haltiwanger, Ron Jarmin & Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young* 2 (Nat’l Bureau of Econ. Research, Working Paper No. 16300, 2010), available at <http://www.nber.org/papers/w16300> (“[F]irm births contribute substantially to both gross and net job creation.”).

¹⁹⁴ *Id.* at 29.

¹⁹⁵ Erik Hurst & Benjamin Wild Pugsley, *What Do Small Businesses Do?* 8 (Nat’l Bureau of Econ. Research, Working Paper No. 17041, 2011), available at <http://www.nber.org/papers/w17041>.

¹⁹⁶ *Id.* at 29–31 (noting that those who start a business for non-pecuniary reasons are less likely to want to grow, to want to innovate, and to actually innovate).

¹⁹⁷ *Id.* at 29–30.

¹⁹⁸ *Id.* at 5.

¹⁹⁹ Sullivan, *supra* note 25, at 55.

²⁰⁰ See Sullivan, *supra* note 7, at 270 (“Tax incentives should be targeted to the subset of small businesses that are fast-growing and innovative.”).

²⁰¹ *Id.*

business as an S corporation is part of its charm and utility.”²⁰² As we have learned, whether a business is eligible for pass-through tax treatment is not a good proxy for the size of the business. Although the rules of Subchapter S do not limit the size of the business, as defined by assets or income, most S corporations are small in terms of assets.²⁰³ Although S corporations can have up to 100 shareholders, the vast majority have three or fewer.²⁰⁴ Yin has concluded that a unified pass-through tax regime would risk failing to meet the needs of both sophisticated and unsophisticated taxpayers.²⁰⁵ While certainly not perfect, Subchapter S is significantly simpler than Subchapter K. While a simple LLC could avoid running afoul of partnership special allocation rules, it is hard to avoid the complexity of Subchapter K. If an owner contributes assets with pre-contribution gain or loss, the assets must be tracked.²⁰⁶ If the business has substantially appreciated inventory or unrealized receivables, and makes a distribution, then the taxpayers must attempt to comply with section 751, an extremely complicated provision known as the “Achilles heel of subchapter K.”²⁰⁷

From a tax administration perspective, Subchapter S has minimal abuse potential, except for employment taxes. Subchapter S already requires taxation of gain on the distribution of assets, as recommended by Yin. With stock ownership restricted to U.S. individuals, S corporations cannot participate in the sort of tax avoidance facilitated by multinational corporations’ use of hybrid entities.²⁰⁸

Subchapter S is a valuable and simple tax system for small businesses. Minor changes to the Subchapter S regime could improve compliance and make life easier for S corporation shareholders. The employment tax difference between partnerships and S corporations should be eliminated, either by imposing employment tax on all net business income allocated to

²⁰² Karlinsky, *supra* note 127, at 355.

²⁰³ See JCT, *supra* note 23, at 5, 7–8.

²⁰⁴ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 106, at 4.

²⁰⁵ Yin, *supra* note 171, at 359.

²⁰⁶ I.R.C. § 704(c)(1)(C) (2012).

²⁰⁷ Yin, *supra* note 171, at 361 (internal citation omitted).

²⁰⁸ See Martin A. Sullivan, *Let’s Promote the Competitiveness of All American Businesses*, 133 TAX NOTES 1175, 1176 (2011), available at <http://taxprof.typepad.com/files/133tn-2.pdf>; see also Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax* 66 (Apr. 1, 2013 draft) (unpublished manuscript) (on file with author) (“Check-the-box creates further opportunities for tax planning through use of hybrid entities in tax havens.”). A hybrid entity is treated as a branch for U.S. tax purposes but as a corporation for foreign tax purposes. See Lee A. Sheppard, *OECD BEPS Action Plan: Trying to Save the System*, 140 TAX NOTES 283, 285 (2013).

2014]

Subchapter S: Vive le Difference!

91

S corporation shareholders, or by allowing LLC members and limited partners to limit the income subject to employment taxes to reasonable compensation.²⁰⁹ S corporation shareholders should be allowed to increase their basis for loss deductions by debt within the S corporation. Because allocations of income and loss are based on ownership of a single class of stock, allocations of debt would be similarly simple under Subchapter S.²¹⁰

²⁰⁹ The first alternative would likely improve compliance, according to the GAO. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 106, at 33.

²¹⁰ Much of the complexity in section 752 relates to special allocations under section 704. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS* 1, 15 (3d ed. 2006) (explaining how section 752 relates to and complicates Subchapter K).

