Integrating Subchapters K and S and Beyond

Walter D. Schwidetzky
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INTRODUCTION

This Article builds upon a similar, lengthier effort that I published in the Tax Lawyer in 2009. While there is overlap, this Article contains much new material. Important case law and tax proposals from the House Ways and Means Committee have come out in the interim. Due to space limitations, unlike my Tax Lawyer effort, this Article attempts to avoid prolixity. It assumes the reader has good knowledge of both Subchapters S and K and the tax entity selection process. If you are not that reader, a review of my Tax Lawyer article or Professor Mann’s article in this symposium edition will fill in the gaps. Generally speaking, I recommend repealing Subchapter S, but integrating its more legitimate benefits into Subchapter K. I also make Subchapter K available to most nonpublic C corporations, putting most closely held businesses on a level playing field.

Part I of this Article provides some context and in a fairly summary fashion reviews the tax advantages that S corporations have over partnerships. Part II looks at income from services and capital and the use of S corporations to avoid self-employment taxes. Part III looks at the possibility of repealing Subchapter K instead of S. Part IV takes a brief look at the nuts and bolts of how my proposal would be implemented. Part V recommends that nonpublic corporations be also allowed to elect Subchapter K, albeit with some continued potential for double taxation in

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1 Walter D. Schwidetzky, Integrating Subchapters S and K—Just Do It, 62 Tax LAW. 749 (2009) [hereinafter Tax Lawyer article].

accordance with current sections 1368 and 1374, and Part VI looks at the pass-through reform proposals of the House Ways and Means Committee chaired by Congressman David Camp ("the Camp Proposals") which came out in 2013 as well as the House Ways and Means’ massive Tax Reform Act of 2014 ("TRA 2014") (hence the “and Beyond” part of the title).

While I will review the tax advantages of S corporations, I generally do not review the tax advantages of tax partnerships, a decidedly longer list. That said, I will make note of two advantages of Subchapter K that I believe are of special importance. One is special allocations, which play a very important role in structuring business transactions. Under section 704(b), partnerships are allowed to allocate items of income and deduction in a manner that is at variance with the underlying ownership of the partnership interests. Thus, someone who is otherwise a 10% partner could be allocated 50% of depreciation deductions. Or, more significantly, the “money partners” can be allocated all of the losses until some form of break-even and then, for example, divide income equally with the “brain partners.” Or, also importantly, large capital contributors may get a preferential return on their capital. The ability to make special allocations plays an important role in getting business deals off the ground. It might be reason by itself to prefer Subchapter K to Subchapter S (where such allocations are not possible). Some have proposed systems that would eliminate special allocations, because of validly perceived abuses that often occur in the special allocation system.\(^3\) But in my view, the answer is to reform section 704(b), not to kill it.\(^4\) Special allocations simply play too valuable a role in everyday business deals, and a lot of business would not get done without them.

The second advantage is section 752, which permits partner-level debt to increase owner-level basis. Subchapter S does not have a section 752 analog, and that creates major problems for business, as well as traps for the unwary. To end-run the problem, S corporation businesses need to have the shareholders borrow the money and contribute or lend it to the corporation. That is in and of itself a little clunky, but becomes a major problem if the debt needs to be secured by S corporation


\(^4\) One cogent reform would be to eliminate special allocations for related parties. See Emily Cauble & Gregg Polsky, Taxing Partnership Allocations Among Related Parties (Apr. 4, 2014) (unpublished manuscript) (on file with author).
assets, as is commonly the case. While resolvable, this creates significant secured transaction headaches.5

Having two pass-through tax regimes creates obvious administrative and other inefficiencies. There was a time when S corporations served a valuable purpose, particularly when taxpayers needed a fairly simple and foolproof pass-through entity that provided a liability shield. But limited liability companies (“LLCs”), which are usually taxed as partnerships,6 in most contexts make S corporations obsolete. LLCs too can be fairly simple and foolproof, while providing the superior tax benefits of the partnership provisions of Subchapter K.7 The advent and popularity of LLCs means that the inefficiency created by two separate pass-through tax regimes can no longer be justified.

It has been difficult to justify Subchapter S for some time. In 1996, I published my first article recommending the repeal of Subchapter S.8 It has been almost twenty years, and I am still at it. There has been the occasional moment of encouragement along the way. In a rather novel experience for a law professor, in 2004 there was a bill in the House of Representatives (H.R. 4137) that would have, among other things, enacted my proposal.9 The bill, however, never became law (or got much of anywhere in the House) and the tax system remains saddled with both tax partnerships and S corporations. H.R. 4137 is discussed in detail in my Tax Lawyer article, but not in this effort.

I. S CORPORATION PLUSES AND WHAT TO DO WITH THEM

S corporations offer a number of legitimate benefits not currently available to tax partnerships, and those benefits should be incorporated into Subchapter K. Some derive from the simple fact that the S corporation is a corporation. For example, parties who anticipate a public offering often use an S corporation, as it is a simple matter to convert it to a C corporation prior to the public offering. While there are publicly traded limited partnerships and LLCs, corporations are much more popular with investors, and the overwhelming majority of publicly traded entities are corporations.

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6 See Treas. Reg. § 301.7701-3(b) (as amended 2006).
7 See Tax Lawyer article, supra note 1, at 759–81.
A partnership can make the transition to a corporation, but it can be a hazardous process. The partnership must first incorporate and then make the public offering of the stock. There may be state law barriers, including transfer taxes. Generally, section 351(a) permits incorporations on a tax-free basis. An issue, however, is whether the requirements of section 351(a) and its 80% control are met. It would normally be met on the initial incorporation, but does the subsequent public offering have to be collapsed together with the incorporation, and if so, does that break the 80% test? The answer to the first question typically is yes, unless there is no binding agreement to engage in the public offering at the time of the incorporation. The answer to the second question is typically no, as long as sufficient public moneys flow into the corporation so that the 80% control test is still met.10 But other contexts are more problematic. An incorporation followed by a reorganization has been held to violate the section 351(a) requirement.11 How can the needs of the parties making these and similar uses of S corporations be met in a world without Subchapter S? The solution I propose is twofold. One part of the solution is to make it easier for partnerships to incorporate under state law. States should cooperate in this regard by providing conversion statutes which permit parties to change entities through a legal, one-step conversion, without formally having to liquidate one entity and transfer the assets to another. This approach would, for example, avoid state income and transfer taxes. The other is to revise the Code so that non-cash out, post-incorporation transactions will not run afoul of sections 351(a) or 368.12

10 There was a common understanding that a binding agreement was necessary (to, for example, engage in a public offering) for the step transaction doctrine to be applied to collapse section 351 transfers, based on Revenue Ruling 78-294 (and particularly the holding in that ruling on a firm commitment underwriting that was not pre-sold). Rev. Rul. 78-294, 1978-2 C.B. 141. However, at the time of the regulatory amendment to section 351 in 1996, the IRS rendered obsolete Revenue Ruling 78-294, and some commentators have viewed that action as signaling that the IRS might now apply a more expansive step transaction test to post-incorporation transfers. See MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 608.3.3.4 (2014). Thanks to Professor Martin Schnall of Boston University Law School for his observations in this regard. See Tax Lawyer article, supra note 1, at 769–84; Treas. Reg. § 1.351-1(a)(3) (1996).

11 See Rev. Rul. 70-140, 1970-1 C.B. 73. Note, however, that Revenue Ruling 2003-51 takes out some of the bite. Rev. Rul. 2003-51, 2003-1 C.B. 938. It both affirms and distinguishes Revenue Ruling 70-140, and surprisingly concludes that the control test of section 351(a) is met, notwithstanding a pre-incorporation binding agreement to dispose of the stock, if the taxpayer could have gotten to the same end result tax-free using a different series of steps.

12 The section 368 reorganization provisions should be amended to make clear that they apply even if the participating corporation has recently incorporated. This amendment is necessary to deal with an attack from the other end of the transaction. While the focus of the rulings to date has been on section 351, there also could be an
Another advantage of an S corporation over a partnership is the so-called capital gain freeze technique. This normally presupposes a taxpayer who owns real estate that is a capital asset\textsuperscript{13} with substantial, inherent long-term capital gains. If the property is sold before development, these gains are taxed at favorable rates. In the case of raw land, for example, the rate commonly is 15\%.\textsuperscript{14} If instead the taxpayer subdivides and develops the land, selling the lots individually, all of the gain on the sales is ordinary income, including the gain inherent in the property before development. Property held for sale in the ordinary course of a trade or business does not qualify as a capital asset, even if it was a capital asset in the hands of the taxpayer previously.\textsuperscript{15}

There is currently a solution to this unhappy state of affairs. Before development, the taxpayer can sell the property to an S corporation the taxpayer (typically) controls. The S corporation then develops and sells the lots. The S corporation’s gain on the sale of the lots is ordinary income, but the pre-development gain is locked in as long-term capital gain to the taxpayer by dint of the taxable sale to the S corporation.\textsuperscript{16} The S corporation takes a fair market value basis in the property upon purchase.\textsuperscript{17} It is very unlikely that the S corporation can be funded with sufficient cash to be able to pay for the property outright. Most likely the S corporation pays with promissory notes that are payable in the future as the S corporation collects revenues from the sale of the lots. Under the installment sale rules of section 453, normally the selling taxpayer only has to recognize his long-term capital gain

\begin{footnotes}
\footnotetext[13]{It is also possible for the property to be a section 1231 asset, which includes real property used in a trade or business. If a taxpayer’s gains from section 1231 assets exceed his losses from those assets, all the gains and all the losses are generally characterized as long-term capital gains and losses. It is probably more common for the property pre-development to be a capital asset.}
\footnotetext[14]{I.R.C. § 1(h)(1)(C) (2012).}
\footnotetext[15]{See I.R.C. § 1221(a)(1); Mauldin v. Comm’r, 195 F.2d 714 (10th Cir. 1952). Section 1237 contains a fairly minor exception.}
\footnotetext[16]{I.R.C. § 1001(c). Query whether section 269 could be applied to stop this technique. It seems unlikely. Section 269 appears to be mostly an anti-abuse rule. Here the taxpayer is just getting the same tax treatment he would have gotten on the sale to a third party. There is no tax arbitrage going on. Generally, the Code specifically regulates related party transactions, and if they are not regulated, I would think the presumption would be that they are allowed. Also, when the Code regulates them, it is, as in sections 1239 or 707(b)(2), to change the character, not ignore the transaction. Thanks to Professor Jay Soled of Rutgers University School of Law for bringing this issue to my attention.}
\footnotetext[17]{I.R.C. § 1012.}
\end{footnotes}
as the notes are paid.\textsuperscript{18} A heavily indebted corporation with a high debt to equity ratio sometimes has to worry about the debt being reclassified as equity.\textsuperscript{19} This is not generally a problem in the S corporation context, however, as long as the debt meets the “[s]traight debt safe harbor.”\textsuperscript{20}

A taxpayer cannot ordinarily achieve this result by selling the property to a tax partnership. Section 707(b)(2) treats a partner’s gain as ordinary income if the partner sells property to a partnership which, in the hands of the partnership, is not a capital asset, and the partner directly or indirectly owns more than 50% of the capital or profits interest in the partnership.\textsuperscript{21} The selling partner, perhaps with other related parties, commonly controls the partnership, and the property in the hands of the partnership is not a capital asset as the partnership uses it in the business of development.\textsuperscript{22} Section 707(b)(2) is generally said to be designed to prevent the following tax arbitrage: The sale gives the partnership a fair market value basis in the property. The likely cost to the related partner seller is long-term capital gains taxed at low rates (but for section 707(b)(2)). Further, the partnership can now depreciate the property from the new, higher basis.\textsuperscript{23} At times the tax benefits of the higher basis to the partnership offset the tax cost to the related selling partner. The risk of tax arbitrage is highly unlikely when the sale is of real property. The depreciation rates for improvements to real property are quite long—27.5 years for residential property and 39 years for commercial property.\textsuperscript{24} Usually, only a mathematically-challenged partner accepts the tax burden of the sale gain today in exchange for a series of relatively small annual depreciation supplements to the partnership for many years in the future. Further, the real property involved in capital gain freezes probably is most often raw land, which is not depreciable at all. If the sale, on the other

\textsuperscript{18} See section 453(e) for limitations that do not usually pose problems.
\textsuperscript{20} See I.R.C. § 1361(c)(5). The debt must be sum certain payable on demand or on a specified date, the interest rate cannot be contingent on profits or the borrower’s discretion, the debt cannot be convertible into stock, and the creditor must be an individual, an estate or trust that is qualified to be an S corporation shareholder, or a professional lender.
\textsuperscript{21} The constructive ownership rules of section 267 apply for purposes of determining whether a partner meets the ownership test. These rules would, for example, attribute partnership interests owned by certain family members to the selling partners. See I.R.C. § 707(b)(3).
\textsuperscript{22} See I.R.C. § 1221(a)(2). The lots held for sale are also not capital assets. See I.R.C. § 1221(a)(1).
\textsuperscript{23} Section 707(b)(2) overlaps with section 1239.
\textsuperscript{24} I.R.C. § 168(c).
hand, is of an apartment building which the parties want to convert to condominiums, the gain equal to depreciation previously taken is typically taxed at a fairly high rate, 25%, making the tax arbitrage more uneconomical and more unlikely.\(^{25}\)

It is not apparent why existing, inherent capital gains should be converted to inherent ordinary income when the use of the property changes. It is appropriate that future appreciation be taxed in a manner that is consistent with the nature of the new use, but not past appreciation. This raises the question of whether an overarching solution should be found that would apply across the board and not just in the partnership context.\(^{26}\) That is worth considering, though it is beyond the scope of this Article.

To bring some rationality to Subchapter K in this regard and further integrate Subchapters S and K, at a minimum, section 707(b)(2) should be amended to provide that it only applies to sales of personal property.\(^{27}\) With this change, the capital gain freeze technique for real property could be implemented with a partnership.

S corporations are also often used to illegitimately reduce or eliminate Social Security and Medicare taxes. There is important new case law in this area which makes a bad problem potentially worse. Of course, the elimination of S corporations will end this abuse. I discuss this topic in detail next.

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\(^{25}\) See I.R.C. § 167; Simon v. Comm’r, 68 F.3d 41 (2d Cir. 1995); see also I.R.C. § 1(h)(1)(D).

\(^{26}\) Why require any long-term capital gain that arose while property was held as an investment to be converted into ordinary income when the property is converted to a different purpose? Why require taxpayers to go through the fiction of a sale? Well, in truth, there could be practical problems. In the classroom, we can make our numbers up, but in the real world, it is hard to know with certainty what the value is at the time property is converted to another use. Also, how will the fisc know if property is truly being held for investment? The current rule effectively requiring a sale to an S corporation (and under my proposal, to a partnership) has the advantage of setting a heralding, reportable event that the Service can audit and upon which it can reach an independent judgment. Another possible solution that does not require a sale is to require a minimum holding period for the property during the investment phase where no significant development takes place, perhaps five years, with an appraisal to be done at the time of conversion by an independently licensed and unrelated appraiser. See I.R.C. § 1237.

\(^{27}\) A conforming change would need to be made to section 1239.
II. INCOME FROM SERVICES, INCOME FROM CAPITAL, AND THE NESE DODGE

A. Some Background

Section 1401 imposes a tax on “net earning from self employment” (“NESE”). The tax has two components. One component is for “old-age, survivors, and disability insurance,” commonly known as Social Security. The tax is 12.4% of NESE. The maximum NESE to which it applies is $117,000 in 2014.28 The other component is for hospital insurance, commonly known as Medicare, and is 2.9% of NESE and applies to all of a taxpayer’s NESE. There is no dollar limit.29 Additionally, the Affordable Care Act added section 1401(b)(2)(A), which imposes a 0.9% tax on NESE for persons earning over $200,000 if they are single, or $250,000 if they are married. The Affordable Care Act also added section 1411, which imposes a 3.8% tax on net investment income for persons with “modified adjusted gross income” in excess of those thresholds.30 Importantly in the S corporation context, net investment income does not include income from an activity in which the taxpayer materially participates.31

NESE is defined as “gross income derived by an individual from any trade or business carried on by such individual, less the deductions attributable to such trade or business, plus his distributive share of income or loss from any trade or business carried on by a partnership of which he is a member.”32 NESE does not include certain kinds of passive income, including portfolio income, capital gain, and similar income (“Excluded Income”).33 I will discuss this in more detail below, but note that in this definition all partnership income other than Excluded Income is included in NESE.

The Social Security and Medicare taxes apply differently to employers and employees. They apply to “wages,” that is, compensation to an employee for services rendered.34 The

28 This amount is adjusted for inflation. See I.R.S. Notice 1036 (Dec. 2013).
29 Individuals are entitled to a trade or business deduction equal to one-half of the self-employment tax. I.R.C. §§ 164(f), 62(a)(1).
30 “Surviving spouses” fall under the higher threshold. I.R.C. § 1411(b)(1). Modified adjusted gross income is adjusted gross income after adding back in the section 911 exclusion. I.R.C. § 1411(d).
31 I.R.C. § 1411(c)(2).
32 I.R.C. § 1402(a).
33 Id. Among the exclusions are certain rentals from real estate, most dividends, certain interest, and certain property gains (typically from the sale of capital assets). See id. Certain retirement payments are also excluded. See I.R.C. § 1402(a)(10).
34 The statutory phrase is “remuneration for employment.” See I.R.C. § 3121(a).
employer and the employee each pay one-half of the Social Security and Medicare taxes. The total tax is the same as it is for the self-employed. Thus, the tax that the employer and employee each pay is 6.2% of wages for Social Security (up to the same maximum that applies to self-employment income) and 1.45% of wages for Medicare (without a maximum). The 0.9% Affordable Care Act tax applies to the employee on his or her wages above the noted thresholds.\textsuperscript{35}

A partner cannot be an employee of a partnership or receive wages from a partnership for services rendered.\textsuperscript{36} Outside of Excluded Income, a general partner’s distributive share of income is always NESE.\textsuperscript{37} NESE does not include the distributive share of any limited partner other than guaranteed payments under section 707(c) for services rendered.\textsuperscript{38} Note that a partner can hold both a limited and general partner interest, and section 1402(a) applies to each separately. The limited partner exception was added to prevent passive investors from obtaining Social Security coverage. Limited partners had originally been subject to Social Security and Medicare taxes to the same extent as general partners, but Congress was concerned that limited partnerships might be established as investment vehicles in order to obtain Social Security coverage, and therefore excluded limited partners in the late 1970s.\textsuperscript{39} Who qualifies as a limited partner is not defined in the Code or Regulations, but it appears from the legislative history and the plain language of the statute that a state law limited partner is intended.\textsuperscript{40} Thus, apparently all tax partners who are not state law limited partners, including LLC members, fall under the general NESE rule.\textsuperscript{41}

To summarize, all income from a trade or business (other than Excluded Income) of any partner (other than a limited partner) is NESE, regardless of the partner’s participation in the business, regardless of the capital invested in the business, and

\textsuperscript{35} See I.R.C. §§ 3101, 3111; I.R.S. Notice 1036 (Dec. 2013); I.R.S. Notice 2007-92, 2007-47 I.R.B. 1036. Notwithstanding this division, there is evidence that employees bear the economic burden of the entire tax. They pay their own share directly and, in effect, the employer’s share through reduced wages. See \textsc{Harvey S. Rosen}, \textsc{Public Finance} 285–86 (7th ed. 2005).
\textsuperscript{36} Rev. Rul. 69-184, 1969-1 C.B. 256.
\textsuperscript{37} I.R.C. § 1402(a).
\textsuperscript{38} I.R.C. § 1402(a)(13).
\textsuperscript{40} See H.R. REP. NO. 95-702, pt. 1, at 40 (1977). At that time, only a state law limited partnership could have been intended, as LLCs and similar entities did not yet exist. See David C. Culpepper et al., \textit{Self-Employment Taxes and Passthrough Entities: Where Are We Now?}, 109 \textsc{Tax Notes} 211, 212 (2005). The Service might be authorized to expand that definition.
\textsuperscript{41} See Culpepper et al., \textit{supra} note 40.
regardless of the character of the business. It is thus very possible for a partner (other than a limited partner) to have NESE that is unrelated to any services performed by the partner.

One might think that both wages and NESE would measure the same thing—income earned from the provision of services. The fact that this is not the case has much to do with the history of the Social Security tax. The Social Security tax structure was originally centered on the employer-employee relationship. In the early years, coverage extended only to limited groups of wage earners. The self-employed were not covered. Thus, originally it was clear that the Social Security tax (the Medicare tax had not yet been created) applied only to income from services. The self-employed originally resisted coverage, but then in the 1950s acquiesced partly due to the fact that meaningful coverage could be had at what at the time was still a low rate of tax. Congress had been concerned about the administrative feasibility of including the self-employed within the Social Security system, particularly with regard to obtaining accurate reports of their income. These concerns were eventually laid to rest and the self-employed were included, but nothing in the legislative history suggests that Congress wanted the focus of the Social Security tax to move from a tax on income from services to a tax on income from services and capital. Further, at the time the self-employed were brought into the fold, much of the discussion seems to have centered on applying the Social Security tax to professionals such as doctors and lawyers, that is, service providers. Thus, when Congress brought the self-employed within the Social Security tax system, it likely thought that NESE primarily focused on income from services. Further, by excluding certain passive income and later income of limited partners (historically, by definition, passive participants), Congress made some effort to exclude from NESE certain kinds of income that are not from services.

Finally, there would have been little logic to expanding the Social Security tax to include income from capital. Why should the type of income subject to Social Security and Medicare taxes for employees be different than that for the self-employed?

42 See Dilley, supra note 39, at 70.
43 Id.
44 Id. at 71.
46 See Dilley, supra note 39, at 71–74.
47 S. REP. No. 81-1669, at 11–12 (1950); see also Yoder v. Harris, 650 F.2d 1170, 1173 (10th Cir. 1981) (discussing the relevant legislative history).
48 See Dilley, supra note 39, at 71–74.
Employers and employees are not being rewarded for using double-tax C corporations as S corporations, which can also have employees and are subject to the same employment tax rules as C corporations. S corporations have been on the scene since 1958 and conceptually since 1946.\footnote{See Act of Sept. 2, 1958, Pub. L. No. 85-866, 72 Stat. 1606. See generally Richard B. Goode, U.S. DEPT. OF THE TREASURY, THE POSTWAR CORPORATION TAX STRUCTURE (1946).} Further, the Social Security benefits one receives are a function of what one pays in.\footnote{See Dilley, supra note 39, at 70.} Why would Congress want the self-employed to have a larger base for benefits than employees? There is thus little logic in applying Social Security and Medicare taxes to income from capital. Further, there is no good reason why passive owners who are limited partners are not subject to self-employment taxes and passive owners who are LLC members are subject to self-employment taxes. In an increasing number of states, limited partners have increasing rights to participate in the affairs of the limited partnership in their capacity as limited partners,\footnote{See UNIF. LTD. PARTNERSHIP ACT § 303 (2001).} making their automatic exclusion from NESE dubious. The logic behind these dichotomies has not been apparent to the Service either.\footnote{Some older private letter rulings treat an LLC member’s share of income as NESE. See, e.g., I.R.S. Priv. Ltr. Rul. 9525058 (June 23, 1995); I.R.S. Priv. Ltr. Rul. 9452024 (Dec. 30, 1994); I.R.S. Priv. Ltr. Rul. 9432018 (Aug. 12, 1994).}

B. Income From Capital Conundrum

In 1997, the Treasury proposed regulations in this area. This was one of several efforts I will outline that attempt to limit NESE to income from services, or at least reduce the amount of income from capital that is included in NESE. The Treasury faced a terminological challenge, in that it had to squeeze its regulations into the statutory general/limited partner structure. It did this by freeing the term “limited partner” in the tax statute from that term in state law statutes. Under the Proposed Regulations, a member of any state law entity that is classified as a partnership for federal income tax purposes can be treated as a limited partner for section 1402 purposes under some circumstances.\footnote{Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). These were preceded by Proposed Treasury Regulation section 1.1402(a)-18, which focused more on LLCs as such. Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67253, 67254 (Dec. 29, 1994).} The Proposed Regulations also partially address the overarching issue of when income is from services and when from capital.
The laudable objective of the Proposed Regulations is to ensure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions are treated similarly. The Proposed Regulations treat an individual as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership’s trade or business for more than 500 hours during the taxable year. Note that if a state law limited partner meets one of the three criteria, he is not a limited partner for section 1402 purposes.

By statute, no member of any type of LLC has general liability for the obligations of the LLC in their capacity as members; thus test (1) of the Proposed Regulations could not apply to an LLC. If an LLC is “member-managed,” commonly all members have the apparent authority to contract on behalf of the LLC. Consequently, usually no member of a member-managed LLC qualifies as a limited partner under the Proposed Regulations. In a “manager-managed” LLC, the managers have the exclusive authority to manage the LLC and typically have the authority to contract on behalf of the LLC. Members who are not managers normally do not have any apparent authority to contract. Consequently, these non-managing members can qualify as limited partners as long as they do not fail the 500-hour test. In states that have adopted the Revised Uniform Limited Liability Company Act (“RULLCA”), members of both types of LLCs are not automatically agents of the LLC. Consequently, in RULLCA-adopted states, the critical test will be whether or not the member participates over 500 hours per year.

56 A limited liability partnership (“LLP”) is a general partnership with a liability shield. Thus, its partners are general partners, who in most states have the authority to contract to the same extent as general partners in general partnerships. Thus, they also would not qualify as limited partners under the Proposed Regulations, irrespective of whether they hold multiple classes of interests or not. See Culpepper et al., supra note 40; CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.05 n.754 (2012).
57 See BISHOP & KLEINBERGER, supra note 56, ¶ 7.02[2].
58 Id. ¶ 7.02[3].
59 UNIF. LTD. LIAB. CO. ACT § 301 (amended 2006). The following states have adopted RULLCA: California, the District of Columbia, Florida, Idaho, Iowa, Nebraska, New Jersey, Utah, and Wyoming.
The Proposed Regulations contain a special rule for services partnerships, under the assumption that virtually everyone involved will be actively performing services. The Proposed Regulations provide that if substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides such services for the partnership cannot be classified as a limited partner, and thus all of his or her income is NESE (other than Excluded Income).

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

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

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61 Under the Proposed Regulations, it is possible to qualify as a limited partner even if the partner participates over 500 hours and does not hold multiple classes of interest. For this rule to apply, limited partners (as normally defined under the Proposed Regulations) must own a substantial, continuing interest in the partnership, and the rights and obligations of the individual in question must be identical to those for the limited partnership class. The underlying presumption apparently is that the partner would be paid for her services, and the rest of any payment should be seen as return on capital. Note that the partnership would still have to have two classes of interest overall. See Prop. Treas. Reg. § 1.1402-2(h)(4), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).
62 The Proposed Regulations, however, permit the bifurcation of interests only to the extent the individual’s rights and obligations with respect to a limited partnership class of interest is identical to the rights and obligations of other partners in that class who (1) qualify as limited partners under the Proposed Regulations without regard to the bifurcation rules, and (2) own a substantial interest in the partnership. See Prop. Treas. Reg. § 1.1402(a)-2(h)(3) to (4), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).
That date has long come and gone without the Treasury taking any additional action on the Proposed Regulations, though they have not been withdrawn. Congress appears to have been concerned about the risk of existing state law limited partners being reclassified as other than limited partners for federal income tax purposes. In fact, this risk was quite slight, as most limited partners doubtless fail all three tests. Further, in those cases where reclassification might happen, it is likely justified. Political pressure, not for the first time, may have taken precedence over sound tax policy, and to date the Treasury has not had the intestinal fortitude to take another run at it.

The difficulty with the Proposed Regulations is that they do not tackle the income-from-capital versus income-from-services issues head on. On the other hand, the Service was bound by the limitations of the statute it was interpreting. The only “out” from NESE was the income allocated to a limited partner. Others have had a freer hand.

The American Institute of Certified Public Accountants (“AICPA”) in 1998, in response to the Proposed Regulations, suggested a statutory change. In broad outline, the AICPA’s proposed amendment provides that partners in tax partnerships have NESE to the extent of the reasonable value of the services performed on behalf of the partnership. It contains a safe harbor for determining the reasonable value of services. If a partner’s NESE varies from the safe harbor by more than 10%, the NESE is subject to reasonableness testing on the basis of facts and circumstances. The safe harbor NESE is the partner’s distributive share of partnership income or loss plus the section 707(c) guaranteed payment for services minus a reasonable rate of return on the partner’s capital account at the beginning of the year. The rate of return on the partner’s capital account is deemed to be reasonable if the rate used is 150% of the

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65 See Culpepper et al., supra note 40.
“applicable federal rate”68 (“AFR”) at the end of the partnership’s tax year.

The proposal has several shortcomings. It does not except services partnerships, the most likely area of abuse, notwithstanding the fact that an objective review of most service partnerships would conclude that all or almost all of their income is NESE. What is worse, given the safe harbor, service partnerships have an incentive to inflate capital accounts to avoid NESE. This could be done by making cash contributions to the partnership and holding them in a money market account. Further, capital accounts69 are usually not precise measures of the value of partners’ invested capital. While they can under some circumstances be “restated” to current value,70 this is relatively uncommon. A partner’s capital account may lag far behind or move far ahead of the value of the partner’s partnership interest. Thus, a reasonable rate of return on the partner’s capital account may yield a meaningless number. Finally, while there is much to be said for bright, predictable lines, the 150% AFR standard is arbitrary. For some industries, the 150% rate could be far high or far low.71 The AICPA provides for additional fudge room by permitting partners to vary from the safe harbor by 10%. Of course, what the AICPA is likely trying to do is limit partners’ NESE as much as practicable.

In 2005, the Staff of the Joint Committee on Taxation (“JCT”) also proposed a statutory change.72 In 2006, the JCT proposed a modified version of its 2005 proposal.73 I discuss these in detail in my Tax Lawyer article. Here I will cut to the chase. Under the modified proposal, all income except Excluded Income is NESE in the case of a partnership engaged in the performance of services in the fields of health, law, engineering, architecture,

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

69 Under the Regulations, capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended 2013).


73 See JCT 2006, supra note 71.
accounting, actuarial science, or consulting ("professional services"). The 2006 effort did not contain a proposal for non-service partnerships.

The American Bar Association Tax Section has taken several runs at this issue. I will focus only on the most recent effort, if for no other reason than I participated in the task force that prepared the Section’s comments.74

In its comments,75 which are fairly brief, the Tax Section objects to the “wholesale expansion” of the income treated as NESE. It is not clear to what expansion the Tax Section is referring. The real expansion is occurring because an unchanged section 1402 is applying to a broader range of businesses and thus a broader range of income, and it is not coming from the JCT. The Tax Section argues that for both service and non-service partnerships, the most appropriate rule is to treat as NESE only that portion of the net income of a partnership that represents reasonable compensation for services rendered. The Tax Section recommends that if the JCT approach for service partnerships is adopted, an exception for “de minimis service partners” be created for those who provide low amounts of services. Under the Tax Section proposal, NESE for de minimis service partners consists of guaranteed payments as well as the partners’ distributive share of income generally, but in the latter case only to the extent it constitutes reasonable compensation for services rendered. With regard to non-services partnerships, the Tax Section argues “strongly” that NESE be limited to an amount that constitutes reasonable compensation, as income also will come from capital. Should that be considered to be administratively unworkable, the Tax Section recommends a complex proposal that includes guaranteed payments as NESE. Additionally, a “material participation partner’s” distributive share of income (other than Excluded Income) is NESE to the extent of reasonable compensation for services. The Tax Section further recommends that there be a rebuttable presumption that guaranteed payments and the distributive share are NESE up to a “presumption amount”; the Tax Section suggests that the maximum income to which the Social Security tax is applied ($117,000 in 2014) be that presumption amount. As I discuss below, it has become common for advisors to S corporations to


75 See A.B.A. SECTION OF TAXATION, COMMENTS ON ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION 7–9 (2006). I do not address the S corporation proposals, as they are mooted by my proposal.
recommend that shareholder employees only take the Social Security tax maximum as a salary and let the rest of the S corporation’s income “flow through” as non-wage income. (Elsewhere in its comments, the Tax Section endorses this approach.) The Tax Section is attempting to obtain official sanction for a practice that likely commonly understates compensation. If the Social Security tax maximum is the presumption amount, it is a safe bet that only ill-informed partners will have compensation income in excess of that amount, and large amounts of what should be compensation income will escape Medicare (and for the more aggressive, Social Security) taxes. Congress and the Service should not entertain such an invitation to end-run the Social Security and Medicare tax system, particularly given the financial difficulties in which Social Security and Medicare find themselves.76

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

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

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

The reasonable compensation for services standard may seem unduly vague, and indeed will create administrative burdens, but in fact it has been one we have lived with for generations. It had been regularly applied in the C corporation context. Commonly there, shareholder employees had attempted to avoid the C corporation double tax by paying themselves a large salary. They argued that as salary, the payment is income to the recipient, deductible to the corporate payor, and thus (they hoped) subject to one level of tax.\textsuperscript{77} Courts have analyzed these purported salary payments under various standards, and if they concluded the salary was unreasonably high, reduced it, with the excess being reclassified as a nondeductible dividend.\textsuperscript{78} There have also been occasions where the courts have looked at whether a salary is too low, as I will discuss below.

Admittedly, allowing courts to resolve compensation issues creates inefficiencies and uncertainties. In a given set of circumstances, taxpayers will not be able to be completely certain if their allocation between compensation and a return on capital will be respected, and it might encourage some to play the audit lottery in the hopes that their abusive scheme will not be uncovered. But the reality is that a fixed rule often will be far off the mark. What is appropriate compensation varies greatly based on the amount of capital involved, the extent of the services provided, the nature of the industry involved, and doubtless a

\textsuperscript{77} See I.R.C. § 162(a) (2012).
\textsuperscript{78} Owensby & Kritikos, Inc. v. Comm’r, 819 F.2d 1315, 1323 (5th Cir. 1987) (applying a multiple-factor test); Exacto Spring Corp. v. Comm’r, 196 F.3d 833, 838 (7th Cir. 1999) (analyzing the reasonableness of the salary based on whether an adequate return was being paid to the shareholders on their investment); see also Haffner’s Serv. Stations, Inc. v. Comm’r, 326 F.3d 1, 4 (1st Cir. 2003) (applying factors but acknowledging the legitimacy of the Exacto Spring decision).
host of other factors. The inequity of a fixed rule in the non-services partnership context argues for a more general standard. Further, the fact that all income (other than Excluded Income) of service partnerships is automatically NESE will ease the administrative burden on the Service and the courts, providing something of an offset.

C. The Scofflaw Gambit

The current definition of NESE means that a taxpayer who wants to avoid Social Security and Medicare taxes will not find the partnership soil very fertile. S corporations are a very different matter. While a partner may not be an employee of a partnership,79 there is nothing to keep a shareholder from being an employee of a corporation, whether it be a C corporation or an S corporation. Employers and employees are only assessed Social Security and Medicare taxes on the compensation that is paid to the employee.80 That fact gives rise to the following tax avoidance technique using S corporations. The S corporation pays a modest salary or perhaps no salary at all to its shareholder employees. The net income of the S corporation not used to pay salaries “flows through” under the regular S corporation section 1366 rules, arguably as non-compensation, and therefore arguably not subject to Social Security and Medicare taxes. For example, in 2014 a neurosurgeon with $1 million of net S corporation income (before salaries) from her services might pay herself the Social Security income maximum of $117,000 as a salary, and let the rest of the income flow through as non-compensation. She thus saves the Medicare tax of 2.9% x $883,000 = $25,607.81 Some

80 See I.R.C. §§ 3101, 3111.
81 Easily the most famous person to use this technique was former Senator, vice presidential nominee, presidential candidate, and bon vivant John Edwards. Over four years (from 1995 to 1998), on income of about $27 million, he saved Medicare taxes of over $590,000. See Michael Moss & Kate Zernike, Campaign Releases Edwards’s Earnings, N.Y. TIMES, July 10, 2004, http://www.nytimes.com/2004/07/10/us/2004-campaign-releases-edwards-s-earnings.html. The journalism on this news story left something to be desired. The technique was portrayed as a legitimate “tax shelter.” If challenged, a court most likely would have held almost all of the S corporation income to be compensation. The specifics: Edwards apparently incorporated midway through 1995. In that year he paid himself a salary of $180,000 on income for the year (including pre-incorporation) of $5 million. In 1996, the S corporation earnings were $4 million and Edwards received a salary of $360,000. In 1997, the S corporation earnings were $11 million and Edwards received a salary of $360,000. In 1998, his final year of law practice, the S corporation earnings were $5.5 million with the same $360,000 salary. See Tom Daley, Letter to the Editor, Edwards’s S Corp: Can We Get the Numbers Right?, 104 TAX NOTES 1310 (2004). The total earnings reported in the Daley piece are somewhat less than in the New York Times article ($25.5 million versus $27 million). I have not found a source for this, but I have heard that the $360,000 salary was based on what the average personal injury lawyer makes in North Carolina, the state where Edwards practiced law.
advisors are routinely telling their clients to pay the Social Security maximum to themselves as salary, and to treat the balance of the S corporation income as non-compensation.\[82\]

This gambit has been going on for many years. Senator Wyden, an Oregon Democrat, calls those who make such inappropriate use of S corporations “Social Security scofflaws.”\[83\] While it would be more fun to call the neurosurgeon example the “Scofflaw gambit,” going forward I will call it the “NESE gambit.” The loss to the fisc from this technique is not insubstantial. The underpayment of Medicare and Social Security taxes through the use of S corporations is estimated to be about $6 billion per year for each tax, or about $12 billion per year in total.\[84\]

Taxpayers have used S corporations to avoid both Social Security taxes and Medicare taxes. Since Social Security taxes are only applied to limited amounts of compensation, S corporation shareholders have to pay themselves relatively low salaries or no salaries to save these taxes. And, in fact, they have done so. The Service has challenged the most piggish gambit users, those that have paid themselves little or no salary. The Service has won all of these cases. Courts have generally concluded that earnings of the S corporation constituted compensation to the shareholder-employees, either under a substance-over-form analysis or by concluding that the distributed earnings constituted reasonable compensation for the services rendered.\[85\] Curiously, the Service has never issued a

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\[83\] See Senate Finance Hearing, supra note 76, at 29–30.

\[84\] In 2005, the Treasury Inspector General for Tax Administration estimated that for 2006–2010, unless the law is changed, the Medicare and Social Security tax gap resulting from under-compensation of Subchapter S shareholder-employees would be $30.2 billion and $30.8 billion, respectively. Id. at 41 (statement of Hon. Russell George, Inspector General for Tax Administration, United States Department of the Treasury). The Government Accountability Office (GAO) issued a report in 2009 outlining S corporation compliance issues. See U.S. GOVT ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009). It estimated $3 billion in employment tax revenue losses over tax years 2003 and 2004—still substantial, but significantly less than the 2005 study. The studies apply to different time frames, which might explain much of the difference. The very substantial gap is still a little perplexing. Given the jump in the use of S corporations, I lean to the former over the latter.

\[85\] See Veterinary Surgical Consultants, P.C. v. Comm’r, 117 T.C. 141 (2001), aff’d, 90 F. App’x 669 (3d Cir. 2004); Nu-Look Design, Inc. v. Comm’r, 356 F.3d 290 (3d Cir. 2004); Specialty Transp. & Delivery Servs., Inc. v. Comm’r, 91 F. App’x 787 (2004); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); W. Mgmt., Inc. v. United States, 45 Fed. Cl. 543 (2000); Radtke, S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), aff’d per curiam, 895 F.2d 1196 (7th Cir. 1990); Dunn & Clark, P.A. v. Comm’r, 853
ruling involving the NESE gambit. It has only issued a ruling where the taxpayer failed to take any salary. Many practitioners are reluctant to advise clients to violate a revenue ruling, and the Service might have saved the fisc billions of dollars had it issued a ruling on the NESE gambit.

In a pure services S corporation, through which, for example, a doctor or a lawyer practices her profession, the NESE gambit is obviously abusive. In the closely-held corporation context, courts generally have required corporations to pay reasonable compensation to their shareholder-employees. In the neurosurgeon example above, all of the income of the S corporation is attributable to her services. Therefore, normally reasonable compensation is all of the net income of the S corporation. Reasonable compensation must be based on the value of the neurosurgeon herself and not, say, the value of the average neurosurgeon. Otherwise the top neurosurgeon in a state making five times the average could argue that her compensation should be based on what the average neurosurgeon earns, or one-fifth of what she is actually earning. That would be an easy way to save Medicare and possibly Social Security taxes. But if that top neurosurgeon went to work for a bona fide employer, she would not accept the average wage—she would insist on being compensated for her actual worth. That is her reasonable compensation.

While there is no hard data, it is highly likely that for most service S corporations, all of the net income of the S corporation represents income from services. As noted earlier, there might be an argument in the occasional service S corporation that there is a sufficient capital investment so that a small percentage of the income is allocable to capital. But clearly what is usually going on is an effort to end-run the Medicare tax and in some cases even the Social Security tax systems. It is axiomatic that

F. Supp. 365 (D. Idaho 1994); Joly v. Comm’r, 76 T.C.M. (CCH) 633 (1998), aff’d, 211 F.3d 1269 (6th Cir. 2000). In these cases, the courts often focused on distributed earnings, and typically most or all of the earnings were distributed. Distribution should not change the analysis. If the S corporation earnings are indeed best classified as wages to the shareholder employees, whether or not they are distributed in a given year should not change the answer. Typically, the shareholder employees have full control over timing. See Charlotte’s Office Boutique, Inc. v. Comm’r, 121 T.C. 89 (2003), aff’d, 425 F.3d 1203 (9th Cir. 2005).

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

Rev. Rul. 74-44, 1974-1 C.B. 287. Thanks to Robert Rombro, Esq. of Baltimore, Maryland for bringing this revenue ruling to my attention.

See Exacto Spring Corp. v. Comm’r, 186 F.3d 833 (7th Cir. 1999); Joly, 76 T.C.M. (CCH) 633.
substance controls form, and for that to occur, in most cases all of the net income of a service S corporation should be subject to Social Security and Medicare taxes.

It was a long wait, but in 2010 there was finally an NESE gambit case. The taxpayer took a small, but not a de minimis salary from his S corporation. While the court did not accept the salary the taxpayer took, sadly it did not require all of the income of the S corporation to be treated as employment income. Indeed, the arguments I made above notwithstanding, the court accepted the argument that only what the average, similarly situated professional made was a measure of the appropriate salary, arguably opening the door wider for taxpayers who wish to avoid employment taxes on their services income. In Watson v. United States, the taxpayer, Watson, formed an S corporation of which he was the sole shareholder. The S corporation was a partner in an accounting firm partnership. The other partners were also one-person S corporations. In 2002, Watson’s S corporation received profit distributions of $203,651 from the partnership. In 2003, it received $175,470 in profit distributions. In each of those years, the S corporation paid Watson a salary of $24,000 per year, let the balance of the income “flow through” as non-compensation income, and paid that balance to Watson as a “dividend.” The trial court and the Eighth Circuit in its affirmation concluded that Watson’s salary and dividend payments were an effort to avoid federal employment taxes, and that the dividends paid to Watson were, in part, remuneration for services performed. The court did not conclude, as it should have, that all of the dividends paid were income for services and subject to federal employment taxes. An expert witness testified that fair market value of Watson’s services for the years in question was about $91,044 per year. Only the difference between that amount and $24,000 was held to be subject to federal employment taxes, interest, and penalties. The fact that a similarly situated taxpayer in a partnership or working as an employee for a large accounting firm would have had to pay employment taxes on all of the net income earned from services seems to have escaped the trial court’s attention, though not that of the Eighth Circuit, as I will discuss.

90 A similar technique was tried unsuccessfully with a limited partnership. See Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011), which admittedly involved a quite abusive fact pattern.
91 Watson, P.C. v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 2010), aff’d, 668 F.3d 1068 (8th Cir. 2012). The Eighth Circuit cited my Tax Lawyer article, supra note 1, in the text of its opinion, but alas did not follow its reasoning.
**Watson** in the short run flings the door wide open for the NESE gambit. Provided taxpayers earn more than the “average,” they can often expect to avoid employment taxes on significant portions of their services income. If *Watson* were the law of the land, query whether it would be worth it to the Service to litigate a case where salaries equal to the Social Security tax maximum were paid, since it often will be likely that the fair market value of the services performed will be relatively close to that amount. Again, under the court’s reasoning in *Watson*, at issue is not the fair market value of the taxpayer’s own services, but those of an average, similarly situated taxpayer, whose services might be worth less than those of the taxpayer in question.

Hopefully the Tax Court\(^\text{92}\) and other circuits will not follow the reasoning in *Watson*. Actually, there was a bit of a waffle in the Eighth Circuit’s affirming opinion. After citing my *Tax Lawyer* article, it stated: “Nevertheless, although we think evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in view of all the evidence presented to the district court in this case, we see no error.”\(^\text{93}\) An optimistic reading of this language would be that the Eighth Circuit was affirming a finding of fact rather than one of law. Certainly, the Eighth Circuit left a door open to reach a different decision under similar facts, and taxpayers in the Eighth Circuit cannot be completely sanguine about their prospects.

The *Renkemeyer*\(^\text{94}\) case also provides some hope that reason will ultimately prevail. *Renkemeyer* involved a similar, but more abusive effort than that in *Watson* with a law firm limited liability partnership.\(^\text{95}\) There the Tax Court generally took the position that income from services is subject to self-employment taxes and cannot be avoided by structural fancy footwork. “The

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\(^{92}\) The Tax Court followed the reasoning of *Watson* in *McAlary Ltd. v. Commissioner*, No. 21068-11S, 2013 WL 4052429 (T.C. Aug. 12, 2013) (summary opinion), an S case, that is, a small tax case that cannot be cited as precedent. Likely the Tax Court did not realize the significance of the case when it accepted the taxpayer’s request to designate it an S case. Thanks to Professors Jensen, Lederman, McMahon, and Todd who brought me up to speed on S cases.

\(^{93}\) *Watson*, 668 F.3d at 1019.

\(^{94}\) *Renkemeyer*, 136 T.C. 137.

\(^{95}\) *Renkemeyer* involved a law firm of tax lawyers organized as an LLP (not a limited partnership). To oversimplify the facts a bit, in 2004 the partners recapitalized the LLP into “general managing partner partnership units” and “investing partnership units,” with the general managing partner partnership units having full authority to act on behalf of the partnership. The vast majority of the income was allocated to the investing partnership units. The partners tried to claim that these should be treated as limited partnership interests and be free from self-employment taxes. The court rejected this approach and held that all of the partnership income was subject to self-employment taxes. *Id.*
legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services... in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.”96 It is hard to see why the Tax Court would not reach a comparable conclusion for the NESE gambit with S corporations.

As long as S corporations can be used to avoid employment taxes, I believe the political hurdles to repealing Subchapter S will be too great. But if this benefit is taken away, the political prospects improve substantially, though one must never forget that the S corporation bar is politically powerful. While there is no data to prove this, I and others believe that the NESE gambit drives the use of S corporations. It is difficult to otherwise explain the substantial popularity of S corporations. My Tax Lawyer article goes into this issue in depth. Also, eliminating this benefit for S corporations in and of itself might strike a major blow for pass-through entity reform. It would make S corporations less popular and its erstwhile proponents less averse to reform. Indeed, without the NESE gambit, S corporations might wither on the vine.

III. REPEAL SUBCHAPTER K INSTEAD?

Much ink has been spilled on the problems with Subchapter K.97 It is surely true that abuses can happen. Subchapter K and its regulations are an extraordinarily complex area of tax law. Of just one piece of this puzzle, the special allocation rules of section 704(b), Professor Lawrence Lokken famously wrote: “[They are] a creation of prodigious complexity... essentially impenetrable to all but those with the time, talent, and determination to become

96 Id. at 150. Section 1402(a)(13) excludes income allocated to a limited partnership interest from self-employment taxes. Thus, even if the taxpayers had formed an actual limited partnership and allocated income to the limited partnership interests, the Tax Court’s language indicates that the limited partner status would not have been respected and self-employment taxes would not have been avoided.

thoroughly prepared experts on the subject.”\textsuperscript{98} Professors George Yin and David Shakow, as Reporters for the American Law Institute, produced an impressive study that was critical of Subchapter K. In it they proposed “an optional tax system” for the simple private business firm grounded in Subchapter K, but “with a strong resemblance to Subchapter S.”\textsuperscript{99} Professors Yin and Shakow did not launch a full frontal assault on Subchapter K, perhaps cognizant of the political perils of such an effort. In addition to the private business firm proposal, they proposed to keep Subchapter K, though with substantial changes.\textsuperscript{100}

I actually think that Subchapter K has much to commend it. The flexibility it offers promotes economic efficiency. Yes, abuses can happen, but I have yet to see any data suggesting that they are a large part of the partnership pie. Professors Yin and Shakow have argued that the complexity of Subchapter K argues for the creation of an alternative, simpler entity.\textsuperscript{101} But the complexity of Subchapter K is to a large extent voluntary. It is perfectly possible to have a simple tax partnership, and there are many. Further, S corporations, with their rigid qualification rules, particularly the one class of stock requirement and the lack of a section 752 analog, are simply unsuitable for many complex business undertakings where income is often allocated in tranches to different owners. But in some ways, this debate is a waste of time. The reality is that repealing or dramatically changing Subchapter K is a political nonstarter. Perhaps the best evidence of that fact is that Professors Yin and Shakow were not able to persuade the American Law Institute, a reform-oriented—and in the view of some, moderately progressive—organization, to adopt their views, notwithstanding that they did not even go so far as to recommend repeal of Subchapter K. Repeal of Subchapter K has never been given serious consideration by Congress. Further, some kind of partnership taxation will always have to be with us if for no other reason than taxpayers can inadvertently find themselves in

\textsuperscript{98} Lawrence Lokken, \textit{Partnership Allocations}, 41 TAX L. REV. 545, 621 (1986).

\textsuperscript{99} See ALI REPORT, supra note 3, at 125. This would have been an elective system. For example, it would have in some cases severely restricted special allocations and would have required gain recognition (as well as loss recognition in the case of a liquidation) on the distribution of assets. See id. at 183 (Proposal 4-2(1)(a)); id. at 215 (Proposal 4-5(1)(a)); id. at 300 (Proposal 5-1(1)(a)); id. at 129 (Table 1); see also Jeffery A. Maine, \textit{Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises}, 62 U. PITT. L. REV. 223 (2000).

\textsuperscript{100} See ALI REPORT, supra note 3, pt. 5, at 273.

\textsuperscript{101} Professor Yin has not changed his mind. See George K. Yin, \textit{Comments on the Taxation of Passsthrough Entities}, 140 TAX NOTES 358 (2013).
a state law partnership. They cannot inadvertently end up in an S corporation. So, if we cannot repeal Subchapter K, surely we should repeal Subchapter S. As noted above, the legitimate benefits of Subchapter S are relatively few in number and can either be incorporated into Subchapter K or be achieved by some adjustments to Subchapter C. Having two pass-through regimes is inefficient. Similarly situated taxpayers are taxed differently, to the advantage of those with skilled advisors, and often to the disadvantage of those with unskilled advisors. This violates principals of vertical equity. Well-advised taxpayers can effectively choose, albeit within limits, how much tax to pay. Taxpayers will exploit the differences between their regimes for their benefit. A classic example is using S corporations for the NESE gambit. Further, the Service is required to train personnel in two different pass-through regimes.

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

IV. LET NONPUBLIC CORPORATIONS COME TO THE PARTY

It seems fair to permit nonpublic state law corporations to elect Subchapter K (or become disregarded entities if they have a single shareholder). As I discuss below, the cost of permitting nonpublic C corporations to do so may now not be large. I would exclude corporations that are currently ineligible for Subchapter S from making this election.

102 See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIPS § 2.01(a) (Supp. 2014).
103 See ALI REPORT, supra note 3, at 45.
104 As did H.R. 4137, so too do I define a nonpublic C corporation as a domestic corporation, no stock of which is readily tradable. See H.R. 4137, 108th Cong. (2004).
105 As did H.R. 4137. Generally, a pass-through regime is highly awkward for these types of entities. See section 1361(b)(2), which lists corporations that are ineligible to elect to be taxed under Subchapter S. Included are financial institutions which use the reserve method of accounting for bad debts described in section 585 (e.g., many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under
C corporations can have highly complex stock and debt structures. In many cases, those structures may make the switch to Subchapter K impractical. But usually, Subchapter K will be up to the challenge. Many partnerships have highly complex ownership and debt structures, but thrive in Subchapter K.\footnote{Closely held businesses should at least have the option of playing on the same field, making for greater horizontal equity. Other countries have taken a uniform approach. I recommend that the United States also take a more uniform approach, though I would not make the election of Subchapter K mandatory for C corporations. As I discussed above, it would be very difficult for nonpublic entities to get by wholly without Subchapter C. As I discuss briefly below, and in more detail in my Tax Lawyer article, I recommend that C corporations be allowed to switch to Subchapter K on a taxpayer-friendly basis.}

State and federal governments are regularly changing the ground under business owners’ feet. An owner who twenty years ago rationally chose a C corporation, might not have done so if he had known of the impending LLC revolution. The tax benefits that he may have gleaned by using a C corporation are, given the overall double tax burden, unlikely to have been so great as to justify locking him into a now outdated choice. Further, why should different nonpublic business entities be taxed differently? Closely held businesses should at least have the option of playing on the same field, making for greater horizontal equity. Other countries have taken a uniform approach. I recommend that the United States also take a more uniform approach, though I would not make the election of Subchapter K mandatory for C corporations. As I discussed above, it would be very difficult for nonpublic entities to get by wholly without Subchapter C. As I discuss briefly below, and in more detail in my Tax Lawyer article, I recommend that C corporations be allowed to switch to Subchapter K on a taxpayer-friendly basis.\footnote{Germany, for example. See Michael J. Munkert, Fallstricke der neuen Thesaurierungsbegünstigung, 10-07 STEUERCONSULTANT 34 (2007).}

V. THE NUTS AND BOLTS IN BRIEF

In my Tax Lawyer article, I discuss in detail how to get from here to there. I will briefly summarize my discussion.

A. S Corporations

A first step toward repeal is to prohibit any further S elections, as of the effective date of any relevant act.\footnote{One might think that permitting C corporations to continue to elect Subchapter S during the ten-year death watch might be a way of facilitating the transition to Subchapter K, but in fact that often, perhaps usually, will not be the case. The S corporation one-class-of-stock rule of section 1361(b)(1)(D) will make Subchapter S unavailable to many existing C corporations. Also, section 1374 will take away much of any tax benefit that Subchapter S provides.} Existing S corporations are given the option of electing Subchapter K or C

section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations. See JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 3.05 (4th ed. 2001).


\footnote{See Small Business Tax Modernization Act, H.R. 4137, 108th Cong. (2004); S Corp Burial, supra note 8, at 643.}
for ten years. If they do neither, they automatically fall under Subchapter K at the end of the ten years.

Generally, an S corporation that shifts to Subchapter K is deemed to liquidate for tax purposes and reform as a tax partnership. This process is necessary (1) to establish capital accounts for the partners correctly;\(^{110}\) (2) for section 704(c), section 707(a)(2)(B), and section 737 to apply properly; and (3) to establish the owner’s bases in the assets properly if the S corporation becomes a disregarded entity. The regular S corporation rules apply until the liquidation, deemed or actual, takes place, with one modification. I apply my recommended reform of Social Security and Medicare taxes to S corporations during the transition period. Thus, all income of an S corporation primarily engaged in the performance of services is subject to Social Security and Medicare taxes. For capital-intensive S corporations, on the other hand, reasonable compensation for services rendered must be paid, but only that compensation is subject to Social Security and Medicare taxes.\(^{111}\)

Generally I recommend that Subchapter K apply to the liquidation of the S corporation as well as, of course, the formation of the tax partnership. Under the current rules of Subchapter S, the liquidating S corporation must generally recognize any gain or loss inherent in its assets.\(^{112}\) It seems inappropriate, however, to apply the current S corporation rules and require gain (or permit loss) recognition on the termination of S corporation status.\(^{113}\) The taxpayers are being forced to use another entity, making gain recognition unfair. Typically, no real disposition is being made. Most owners will continue the same business.\(^{114}\) This makes loss recognition inappropriate. I therefore recommend that S corporations and their shareholders be allowed to move to partnerships or disregarded entities using Subchapter K.

Sufficiently creative taxpayers can find ways of inappropriately taking advantage of these generous rules for

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111 Perhaps the easiest way to accomplish this is to bring S corporations under the self-employment rules, as opposed to continuing their current coverage under sections 3101, 3111, and related provisions. See STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 68 (Comm. Print 2008); H.R. 3970, 110th Cong. § 1211 (2007).


113 See I.R.C. §§ 331(a), 336(a).

114 They may want to actually liquidate the S corporation and form, for example, an LLC. See S Corp Burial, supra note 8, at 616. Or they may want to continue using the state law corporation, which either is disregarded for tax purposes if it has a single owner, or is taxed under Subchapter K if it has multiple owners. Id. at 611; I.R.C. § 701.
liquidation of S corporations. To stop or at least impede this, I recommend Congress authorize the Service to adopt an anti-abuse rule that applies to this process.\textsuperscript{115}

Note that under my proposal, S corporations do not have the option of liquidating under the current S corporation rules. This is to prevent taxpayers from cherry-picking tax treatment, that is, using Subchapter S for S corporations with net losses in their assets and Subchapter K for S corporations with net gains. It is appropriate, however, to have a brief transition period of perhaps one year where S corporations are allowed to actually liquidate under either Subchapter K or S. Taxpayers planning to liquidate in fact should not be caught unawares by the statutory change. While cherry-picking can happen during the one year, the associated revenue losses are not likely to be great given the limited time frame. Further, S corporation losses and deductions, including depreciation deductions, generally flow through to the shareholders.\textsuperscript{116} In other words, the losses have often already been recognized by the shareholders. As a consequence, it is not likely that there are a large number of S corporations with large amounts of losses inherent in their assets, though there will be some with economic losses that have not yet been taken into account for tax purposes.\textsuperscript{117}

While it is difficult to predict with certainty in the absence of hard data, it seems doubtful that permitting largely tax-free liquidations of S corporations will generate unacceptable revenue losses for the fisc. Under the current rules, S corporations can avoid distributing assets that contain significant amounts of appreciation. Instead, they commonly retain the property in corporate solution, depriving the government of a recognition event. In addition, Social Security and Medicare tax revenues will no longer be lost, creating a substantial offset, indeed likely a net revenue increase.

What if the S corporation has earnings and profits or unrecognized section 1374 gains? The equities in this regard are not as strong as the equities in favor of allowing non-recognition of the (non-section 1374) gains and losses inherent in the S

\textsuperscript{115} One example: A and B own all of the stock of an S corporation. A individually owns asset X and B individually owns asset Y. They wish to exchange these assets with each other. The assets do not qualify for like-kind exchange treatment under section 1031. To avoid gain recognition, they could each contribute the assets to the S corporation. The contribution would be tax free under section 351(a). As part of a subsequent liquidation of the S corporation under Subchapter K, the S corporation could distribute asset Y to A and asset X to B, potentially tax free. See I.R.C. § 731.

\textsuperscript{116} I.R.C. § 1366.

\textsuperscript{117} A drop in the value of land, for example, would normally only be recognized in the case of taxable disposition, as land is not depreciable. See I.R.C. § 1001.
corporation assets. The earnings and profits and section 1374 gains originated with a C corporation, and avoiding any tax consequence also avoids what would have been part of the Subchapter C double tax system, and Subchapter C is not being recommended for repeal. Here I depart from my Tax Lawyer article and follow the lead of the Camp proposals discussed below. The accumulated adjustments account\textsuperscript{118} with the relevant section 1368 potential dividend treatment and the section 1374 treatment carry over from the erstwhile S corporation to the new entity, be it a tax partnership or a disregarded entity, with credit given for that portion of the ten-year section 1374 time period that elapsed while an S corporation. Further, during the transition period, current rules apply to the section 1374 gains.

Should the proposed act contain continuity of business enterprise and ownership interest tests? Should the business of the erstwhile S corporation be required to be continued for some period of time? Should the erstwhile shareholders be required to stay on as partners for some period of time?\textsuperscript{119} Should a special rule be applied to S corporations that actually liquidate and discontinue the business? While the failure to address these issues may mean that some owners will be able to convert corporate assets to personal use without an income tax effect,\textsuperscript{120} on the whole, the better answer to the question is not to apply continuity of interest standards or special rules for actual liquidations and discontinuance of the business. Because S corporations are being forced out of existence, the equities favor an owner-friendly set of rules. Also, aside from the possibility of converting business assets to personal use, which will likely be uncommon, the relevant tax consequences after the conversion are similar to, or even worse than, those before the conversion. Some examples: a sale of stock in the S corporation usually generates a capital gain or loss; the sale of a partnership interest may generate ordinary income (i.e., worse off in a partnership);\textsuperscript{121} the gain or loss on the sale of business assets generally flows through to the shareholders for S corporations and to partners for partnerships (i.e., treatment unchanged). Also, determining whether the continuity tests are met will create additional

\textsuperscript{118} I.R.C. § 1368(e).
\textsuperscript{119} These rules apply to corporate reorganizations. See Bittker & Eustice, supra note 19, ¶¶ 12.21, 12.61[2].
\textsuperscript{120} This could not happen with an S corporation, since the distribution of property by an S corporation to its shareholders causes gain and possibly loss to be recognized under sections 311(b) and 336. On the other hand, a distribution of property by a partnership to a partner is generally not recognized to either party. See I.R.C. § 731. But see I.R.C. §§ 707(a)(2)(B), 704(c)(1)(B), 737, 751(b).
\textsuperscript{121} See I.R.C. § 751(a).
complexity that does not seem worth the statutory effort. Numerous questions will arise. How long should the business be operated? What if the assets are used in a different business? How much of an ownership change is permitted? Many of these issues have been addressed in the corporate context. But in the case of S corporations being forced out of existence, the courts might address these issues differently. Further, if continuity provisions are enacted, most owners likely will continue the business long enough to pass muster, so little revenue will be raised.

B. C Corporations

For newly formed C corporations electing to be taxed under Subchapter K, rules will need to be developed that track the section 704(b) allocation rules with the multiple classes of stock possible in a C corporation. Other special issues may arise, but they should be manageable. A separate question arises for existing nonpublic C corporations wishing to elect Subchapter K (or disregarded entity status). How should they get from here to there? Assuming it does not create undue fiscal burdens, I recommend taking the same approach as for S corporations (including section 1368 accumulated adjustment accounts and section 1374). As Subchapter C would be continuing, I do not make this approach mandatory as I do for S corporations. It would be almost impossible to keep track of C corporations liquidating for independent reasons and those liquidating to continue under Subchapter K. Thus, C corporations have the option of liquidating under the current rules, which they will prefer if overall it generates losses. An anti-abuse rule should be created so that C corporations cannot switch to the new rules and then promptly formally liquidate to avoid double taxation. They might be required to continue the business for two years, for example. For the reasons noted above for S corporations, however, I would not apply other continuity of interest rules.

Some will view my proposal as an unduly liberal give-away. And indeed, as I discuss below, its cost may be too high. But there are also economic inefficiencies that are created when some taxpayers are forced to operate within an outdated form and others are not. New businesses forming LLCs have a competitive advantage over older businesses trapped in C corporations. Electing S corporation status may not be available

122 See BITTKER & EUSTICE, supra note 19, ¶¶ 12.21, 12.61[2].
123 It is not out of the question they will prefer it in a gain situation, as it means a basis step up. See I.R.C. § 732.
if their ownership structure does not permit a single class of stock. Leveling the playing field should make for a more efficient economy.

If the costs to the fisc of my proposal for existing C corporations are too high, a simple solution, and probably as reasonable as any, is simply to leave the current rules for liquidating C corporations in effect with one adjustment: existing nonpublic C corporations may, during the ten-year window, elect Subchapter K or disregarded entity status, but if they do so they are deemed to liquidate under Subchapter C, recognizing the gains and possibly the losses per its rules.\textsuperscript{124} To limit the tax pain, any taxes owed are payable over five years. Again, an anti-abuse rule should apply to prevent C corporations from electing Subchapter K and then liquidating soon thereafter to take advantage of the five-year payout.

Whichever of these rules are used for existing C corporations, they should only apply during the ten-year window. To allow these tax benefits for C corporations that liquidate after the ten-year window is to permit them to have their cake and eat it too, using Subchapter C when it is beneficial and switching to Subchapter K when it is not, indefinitely.

Assuming a favorable environment in which qualifying C corporations can elect Subchapter K at a low tax cost, will the LLC revolution be reversed or at least slowed? Rather than forming LLCs, will taxpayers form corporations and elect Subchapter K? While this is not necessarily a bad thing, it is not a likelihood for non-tax reasons. State LLC statutes have more modern, flexible statutory architectures in comparison to typical corporate statutes.\textsuperscript{125} Indeed, many who prefer for whatever reason to operate as C corporations for tax purposes often form LLCs and then check the box to be taxed as C corporations to take advantage of the greater state law flexibility LLCs offer.\textsuperscript{126}

VI. CAMP PROPOSALS AND TRA 2014

In March of 2013, the Chairman of the United States House of Representatives Ways and Means Committee, David Camp, published options for pass-through entity tax reform.\textsuperscript{127} “Option

\textsuperscript{124} Of course, a C corporation can always actually liquidate and form a partnership with all the attendant tax consequences. See I.R.C. §§ 346, 332.

\textsuperscript{125} See BISHOP & KLEINBERGER, supra note 56, ¶ 1.02.

\textsuperscript{126} LLCs can also elect to be taxed as S corporations. See INTERNAL REVENUE SERV., FORM 8832 (2013), available at http://www.irs.gov/pub/irs-pdf/f8832.pdf.

“Integrating Subchapters K and S and Beyond”

1” keeps Subchapters K and S, but makes recommendations for reform. In general, these are more taxpayer friendly for S than for K. “Option 2” repeals Subchapters K and S and replaces them with a new Subchapter K which departs from the current version at times in dramatic fashion. Option 2 would automatically apply to tax partnerships. Option 2 would allow corporations to elect the new Subchapter K, provided they are not publicly traded. Insurance companies, DISCs, and most banks could not make that election. I briefly discuss Option 1 and Option 2 below.

But things get still more dramatic. In February 2014, the House Ways and Means Committee proposed the Tax Reform Act of 2014128 (“TRA 2014”). This massive proposal contains some provisions of significant relevance to this Article, and is also discussed briefly below.

A. Option 1

Option 1 contains a diverse series of changes. There does not seem to be any main theme, but rather a desire to make a number of independent fixes. Some are laudable, some not, and some are hard to get excited about one way or the other. I will not attempt a blow-by-blow review, but a few of the changes are worthy of special note.

Option 1 would repeal section 707(c) guaranteed payments. Thus, payments to a partner would either have to fall under the third party rules of section 707(a) or the regular rules for distributions to partners of section 731. Section 707(c) has always been a bit of an odd duck, trying to split the difference between sections 707(a) and 731, and it is a code provision Subchapter K can live without. So this is a change that makes sense.

Section 736 would also be repealed. This is perhaps my least favorite code section in all of Subchapter K. It works very awkwardly and under limited circumstances permits quick deductions for payments for goodwill. “[T]ime has passed section 736 by, and, rather than serve its initial purpose, section 736

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survives as an anachronism preventing the coherent evolution of the Code.” ¹²⁹ This is another laudable change.

Less laudable is the provision that would make section 754 elections mandatory, with a few twists in the case of their application of section 734(b). Mandatory section 754 elections, while more theoretically pristine, can pose a large burden on business, especially small business. At a minimum, small partnerships should be excluded.

Option 1 would also eliminate the current seven-year window for mixing bowl transactions under sections 704(c)(1)(B) and 737. This would pose a major recordkeeping burden, perhaps an impossible one, on partnerships, especially small partnerships. It is also very difficult to justify on policy grounds. The seven-year window is already quite long and should stop almost all mixing bowl tax games. This provision of Option 1 fixes a non-problem.

B. Option 2

If one wanted to come up with an option that would make no one happy, be opposed by almost everyone, and have no chance of ever being enacted, it would be hard to do better than Option 2. A respected commentator has called it a “good starting point for the tax reform debate.”¹³⁰ I fear that this view is too optimistic. It is hard to get a debate going when the House Ways and Means Committee comes out with a proposal most of which hardly anyone will want. Any serious counterproposal would be substantially different, making compromise very difficult.

Option 2 often refers to its new Subchapter K entity as a “passthrough,” and I will use the same nomenclature. Option 2 has many Subchapter K-like provisions. There are equivalents or near equivalents to sections 704(c), 704(d), 705, 706, 707(a) and (b), 708, 721,¹³¹ 722, 723, 724, and 751. Option 2 eliminates special allocations, as I noted above, a valuable benefit to legitimate business undertakings. It requires a partner’s distributive share to be fixed within each of three categories: ordinary items, capital items, and tax credits (it does

¹³¹ Note that inasmuch as Option 2 follows current section 721, owners do not have to meet section 351-like control requirements when contributing assets to a partnership. See TECHNICAL EXPLANATION, supra note 127, at 48.
not have to be the same across the categories). An owner’s distributive share must be consistent with the owner’s economic interest. The owner’s economic interest is to be determined under all facts and circumstances. One might think that without special allocations, owners likely would usually have straightforward, fixed allocation percentages that would not impose large compliance problems. But owners might try to end-run the rules by having allocations vary from year to year. Further, it is unclear how a service partner receiving a future profits interest would calculate his economic interest. Thus, we could expect some fairly complex regulations on determining an owner’s economic interest. Option 2 does not address capital accounts. They likely would still be necessary to determine an owner’s economic interest. Further guidance will be necessary in this regard. How does the taxpayer determine her capital account when an entity converts from, for example, Subchapter S to new Subchapter K? In my proposals, I address this by having the electing entity go through a deemed liquidation/reformation process. The bottom line, though, is that eliminating special allocations is likely a deal killer.

Option 2 adopts the equivalent of current sections 301(b)(1), (c)(2), (c)(3), and 311. Thus, as would be the case in a distribution from an S or C corporation, the passthrough recognizes a gain, but not a loss, on the distribution of property. The owner recognizes a capital gain if the fair market value of the distributed property exceeds her basis in the ownership interest (subject to the equivalent of section 751(b)). A loss could be recognized on liquidation of the ownership interest. In the case of a gain asset, the owner typically takes a fair market value basis in the distributed property. In the case of a loss asset, the owner typically takes a carryover basis. As under current section 732(a)(2), the owner cannot take a greater basis in the distributed property than she had as an outside basis in the ownership interest plus any gain recognized by the owner on the distribution. Logically, the outside basis is reduced by the basis taken in the distributed property, but not below zero. In fairness, requiring gain recognition would eliminate some “game playing” that takes place now and much of the need for mixing bowl rules. Indeed, Option 2 contains no analog to sections 704(c)(1)(B) or

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132 Id. at 45. Exceptions are made for contributed property, to which the equivalent of section 704(e) will apply, and section 751-like rules designed to preserve a partner’s share of ordinary income. Id. at 45–47; see also I.R.C. § 751(a) (2012).
133 See Jackel, supra note 130, at 1366.
737, though it has a version of section 707(a)(2)(B). The requirement that gain be recognized on a distribution will be very unpopular, though perhaps not the deal killer that eliminating special allocations likely is.

Option 2 makes what is now a section 754 election mandatory. Again, this would be very burdensome for, and unpopular with, small business and could evolve into a major recordkeeping headache. Option 2 reconfigures the equivalent of section 734(b) in a way that makes it more accurate than the current version, albeit in a highly complex way. Of course, this additional complexity will make life just that much harder for small business.

In what appears to be a major, but sad, nod to current S corporation users, Option 2 may be continuing the ability to avoid self-employment taxes. I say may be, because the language is cryptic and at dramatic disjuncture with the position TRA 2014 takes. Option 2 states: “The [new section 707(a)] also applies when an owner performs services for the passthrough and is paid reasonable compensation, including wages, by the passthrough for such services.” If indeed this language is meant to continue self-employment tax avoidance, it would go a long way to appeasing current S corporation users, but for the reasons noted above, would constitute terrible tax policy. Also, there are likely many in Congress, especially on the Democratic side of the aisle, who would resist this approach. So while it adds allies, it also adds opponents. It is also not clear how this effort, without more, would work. How would Option 2 passthroughs be treated under section 1402? Section 1402 does not contemplate them, of course, and without amendments to section 1402, it is not an inevitability that the pass-through “wage payments” would be respected for self-employment tax purposes to the extent wage payments from S corporations may be. A court might conclude that the passthrough should be treated as a partnership under section 1402. It would be thus necessary to amend section 1402. That would have the benefit of bringing the issue to a head. But that likely is exactly what current users of S corporations do not want, as it would be very difficult to justify the avoidance of self-employment taxes. Thus, what looks like a provision S corporation users might support could end up being one that also causes them to oppose Option 2. However, perhaps the implied nod to self-employment tax avoidance was unintended, because TRA 2014 addresses this issue directly and very differently, as I discuss below.

135 See Jackel, supra note 130, at 1366.
Option 2 has the equivalent of current section 707(b)(2). Thus, the capital gain freeze technique discussed above that is currently available with S corporations would no longer be available. This would endear the new provisions to almost no one (with the possible exception of a few law professors).

It adds the equivalent of current section 752, albeit one that is short on details.\textsuperscript{136} As noted, its absence from Subchapter S had at times been a major problem for S corporation shareholders. So this would be a plus for them, but neutral to those operating under Subchapter K.

Option 2 permits most non-publicly traded C corporations\textsuperscript{137} to elect the new Subchapter K. There are few other limits. In contrast with current Subchapter S, there is no limit on the number of shareholders, classes of ownership interest, or who may be a shareholder. Indeed, there is not even a requirement that the corporation be domestic. This election must be counted as a plus, as is the way it addresses existing double taxation issues, following current sections 1368 and 1374. An electing C corporation’s earnings and profits would carry over to the new entity, which would be required to keep an accumulated adjustment account. Distributions in excess of that account would be treated as dividends to the extent of erstwhile earnings and profits. If the corporation sells assets it held while a C corporation within five years of election of the new Subchapter K, it must recognize a corporate level gain (and pay tax on that gain at the highest corporate tax rate) to the extent of the net gains inherent in corporate assets at the time of the election. If an S corporation elects the new Subchapter K, and current section 1374 applied to the S corporation, the new Subchapter K’s section 1374 equivalent will apply. But the new passthrough gets credit against the five years for so much of that time period as applied while under the old rules. (Note that Option 2 reduces the current ten-year section 1374 window to five years.)

Option 2 continues current section 1375 and assesses a corporate level tax at the highest rate on excess passive investment income, if the passthrough has earnings and profits from its C corporation days. However, the current law threshold of 25% of gross receipts is increased to 60%.

Strikingly, Option 2 does not discuss the receipt of an ownership interest for services. Generally, currently the receipt

\textsuperscript{136} See id. at 1364.

\textsuperscript{137} Insurance companies, current or former domestic international sales corporations, and most banks may not make the election. See TECHNICAL EXPLANATION, supra note 127, at 43.
of a pure, future partnership profits interest for services is not income, while the receipt of stock in an S corporation is.\textsuperscript{138} This is a highly controversial area, and certainly any new Subchapter K would need to address this issue.

Last, but far from least, Option 2 assesses a withholding tax on the passthrough based on an owner’s distributive share of net ordinary income and net capital gains. The withholding percentage is not specified and can be different for ordinary income and capital gains if the owner’s distributive shares are different. This would likely only come in second to eliminating special allocations for unpopularity. It is doubtless a well-intended measure to increase compliance, and indeed, improving compliance is a laudable objective. But there is a limit to how many unpopular measures you can load into a given tax act and expect to succeed. Option 2 is way past that limit.

Most current nonpublic C corporations that cannot qualify for current Subchapter S will find something to cheer about in Option 2. But there is little in Option 2 which would enthuse either a current Subchapter K or current Subchapter S supporter. Under those circumstances, it is difficult to see how Option 2 ever gets off the dime. But, as I noted above, it also constitutes a major impediment for other systemic reform proposals which likely would be at substantial variance with Option 2.

C. TRA 2014

A law professor could spend several years writing law review articles about this massive legislative proposal which takes no prisoners. Luckily, here I can be fairly brief. One overarching comment: While there is much I do not agree with in TRA 2014, one cannot fairly claim the drafters just played favorites. They took on some of the sacred cows of the wealthy. Also note that TRA 2014 retains both Subchapters K and S with changes and makes no attempt to implement Option 2.

One of the sacred cows that TRA 2014 takes on is the use of S corporations to avoid self-employment taxes. At the same time, the drafters make an attempt to address the problem of distinguishing income from services from income from capital. Under TRA 2014,\textsuperscript{139} self-employment taxes would apply to general and limited partners of a partnership (including limited


\textsuperscript{139} TRA 2014, supra note 128, § 1502, at 32–33.
liability companies), as well as to shareholders of an S corporation to the extent of their distributive share of the entity’s income or loss (except for Excluded Income). Partners and S corporation shareholders who materially participate\(^\text{140}\) in the trade or business of the partnership or S corporation would treat 70% of their combined compensation and distributive share of the entity’s income as net earnings from self-employment (and thus subject to self-employment taxes), and the remaining 30% as earnings on invested capital not subject to those taxes. For partners and S corporation shareholders who do not materially participate in the trade or business (TRA 2014 calls them, not always correctly, passive investors), none of the income would be subject to self-employment taxes.

The TRA 2014 Discussion Draft states that this distinction between net earnings from self-employment and other income reflects the fact that over the last several decades, the portion of GDP attributable to labor has remained remarkably constant at approximately 70%, while the portion of GDP attributable to capital has held steady at roughly 30%.

I believe that the drafters are to be commended both for taking on the use of S corporations to avoid self-employment taxes, and for attempting to distinguish income from services from income from capital. An across-the-board 70%/30% split certainly has the advantage of setting a bright line. But, as I discussed above, for most service businesses, almost no income will come from capital, yet 30% will not be subject to self-employment taxes. For capital intensive businesses, 30% may be wildly low. A bright line that, likely more often than not, is at great disjuncture from reality, cannot be justified. The more nuanced approach like the one I suggest above is more likely to get to the right answer more often.

TRA 2014 also contains changes for tax partnerships and S corporations. For the most part, the TRA 2014 changes track Option 1 discussed above. One startling departure, however, is that TRA 2014 would repeal section 708. “Thus, [a] partnership would be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted” (as they are currently).\(^\text{141}\) No explanation was given

\(^{140}\) This term is taken from section 469, containing the so-called “passive loss rules.” See I.R.C. § 469(c)(1)(B). Material participation is defined in Treasury Regulation section 1.469-5T in various ways. See Treas. Reg. § 1.469-5T(a) (1996). One way to materially participate is to participate in an activity over 500 hours per year.

\(^{141}\) TRA 2014, supra note 128, § 3619, at 119.
for this change, and it could be accused of fixing something that is not broken. It makes little sense to bind a partnership to elections it made when it had an entirely different set of partners. Indeed, repealing section 708 would often make it difficult to find parties to buy partnership interests. It is true that Option 1 eliminates some elections, but hardly all, and it is difficult to see this change as anything other than mystifying.

Another substantial, and vastly more defensible, addition to Option 1 is a new rule for carried interests. Fully engaging this topic would require a separate article, but suffice it to say that currently, partners performing services for investment partnerships are often able to have income from their services classified as capital gains. TRA 2014 takes on this sacred cow and classifies the income as ordinary in many circumstances.\(^{142}\)

TRA 2014 has no chance of ever being enacted. But, unlike Option 2, which as noted above might stifle discussion and reform, the boldness of TRA 2014 and its willingness to play hardball may indeed encourage discussion of important tax issues. With a little luck, TRA 2014 may jump-start genuine, large-scale tax reform.

CONCLUSION

While neither Option 2 of the Camp proposals nor TRA 2014 is politically realistic, the repeal of Subchapter S is likely possible if the use of S corporations for self-employment tax avoidance is stopped. The repeal of Subchapter S will make the U.S. tax system more efficient. The country does not need two pass-through business entity tax regimes, and only the repeal of Subchapter S is politically realistic. A few relatively modest Code changes permit the important, defensible benefits of Subchapter S to be retained. The repeal of Subchapter S allows the Service to make better use of its personnel. It also makes for readier reform of Subchapter K. The Treasury and Congress, their attention no longer divided between two tax systems, and their limited human resources no longer spread as thin, can bring greater focus to that task. Finally, the time has come to allow nonpublic C corporations to elect Subchapter K as well, ideally on a taxpayer-friendly basis. Shareholders should not be trapped with an antiquated choice.