Comments on the Taxation Of Passthrough Entities
By George K. Yin

A. Introduction and Summary

This article provides comments on four of the proposals contained in the House Ways and Means Committee’s March 12 discussion draft to reform the taxation of passthrough entities. These recommendations are as follows:

- **Unified passthrough tax rules:** A “two-track” approach to passthrough taxation, generally along the lines of existing subchapters K and S, should be retained, but differences between the two systems generally should be limited to the policy goal of providing simplification benefits and reduced compliance costs to businesses with straightforward financial structures.

- **Nonpublic corporations:** All nonpublic businesses (other than sole proprietorships), including those currently taxed under the operating rules of subchapter C, should generally be taxed under one of the two passthrough tax systems.

- **Distributions by passthrough entities:** Subchapter K should be revised to incorporate the distribution proposals contained in the Ways and Means discussion draft. I believe this single revision to current law would be a meaningful step toward realizing the committee’s dual goals of simplification and reform in this area.

- **Allocation of distributive shares:** Although the tax treatment of partnership allocations is badly in need of reform, the discussion draft’s proposed changes in that area should probably not be adopted.

- **Section 1374 recognition period:** Finally, section 1374 should be reformed to have an unlimited recognition period but with only a single tax being imposed when the provision is applicable. This compromise would clearly be preferable to the discussion draft’s proposed reduction of the recognition period to five years.

1. Uniform set of tax rules for certain nonpublic businesses. In general, the discussion draft provides a uniform set of tax rules for all businesses currently taxed under subchapter K and nonpublic corporations that elect to be taxed under the new rules. Presumably, nonpublic corporations that do not make the election will be taxed under the operating rules of subchapter C. The provision repeals existing subchapters K and S.

Although greater uniformity in taxation has certain theoretical benefits, it also entails potential costs. The compliance costs of taxpayers may be increased, depending on the diversity of the businesses subject to the single set of rules. As the American Law Institute (ALI) Reporters’ Study stated, “A single tax system that addresses the disparate tax issues of a diverse population of taxpayers may be too unwieldy for an important segment of that population. In that case, there may be advantage to identifying a somewhat less diverse subgroup of the population and designing a separate set of tax rules just for them.” The tax system already recognizes this principle in several instances, such as by allowing individuals to use different tax return filing forms and to elect a standard deduction in lieu of itemizing. Another
potential cost of increased uniformity is reduced flexibility to lawmakers in implementing tax policy. Uniformity places considerable pressure on the specific rules selected and if there are broad differences in the taxpayers subject to the single set of rules, there is significant risk that the uniform system will produce an “unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.”

The distinction under current law between subchapters K and S is instructive. The key eligibility condition for subchapter S is the “one class of stock” rule. This condition is tied to the source of the main complication in passthrough taxation, which is the treatment of businesses with more complex financial structures than those eligible for subchapter S. Thus, taxpayers are in effect given a choice of surrendering some economic flexibility in exchange for a simpler set of tax rules and reduced compliance costs. By limiting the class of taxpayers eligible for the simplified rules, lawmakers are able to provide a streamlined system that nevertheless produces proper tax policy outcomes. Recent history has shown the popularity of maintaining a two-track approach in the taxation of passthrough entities.

Although it recognized the potential policy advantages of uniformity, the Reporters’ Study ultimately concluded that it was preferable to maintain two general passthrough tax systems for private businesses. In general, it recommended a simpler set of rules (modeled after current subchapter S) for businesses with only one class of residual ownership interests (and satisfying certain other ownership conditions), and a default set of tax rules (modeled after current subchapter K) for all other private businesses. For the same reasons, I believe it would be wise to continue two passthrough tax systems, with eligibility for each system determined largely by the complexity of the taxpayer’s financial structure and certain other ownership limitations. Eligibility conditions unrelated to the source of complexity in passthrough taxation — including, for example, whether a business is incorporated should generally be eliminated. Thus, incorporated and unincorporated private businesses should both be entitled to elect the simpler passthrough tax structure as long as they satisfy conditions ensuring that they cannot use the structure to produce improper tax outcomes.

If the committee concludes that two passthrough systems are warranted, I would urge two modifications to current law. First, any differences between the two systems should be limited as much as possible to those relating to simplification benefits and compliance costs. For example, if it is possible under the simpler rule structure (without loss of simplification benefits) to include entity-level debt in outside basis, or to allow a limited class of preferred ownership interests, those changes should be considered. Also, differences in the employment tax consequences under the two systems and their treatment of distributions should generally be eliminated.

Second, all private businesses (other than sole proprietorships) should generally be taxed under one of the two systems. Specifically, nonpublic corporations should not be entitled to be taxed under the operating rules of subchapter C. In general, this latter change would reserve the subchapter C operating rules for public corporations and enable significant simplification of those rules. Moreover, it would prevent taxpayers from using C corporations as tax shelters in light of current and

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4Id. at 115.
5See section 1361(b)(1)(D).
6Some taxpayers choose subchapters K or S because of tax advantages and not based on the trade-off between economic flexibility and compliance costs. As noted below, differences between the two systems that are not necessitated by the policy of providing simplification benefits and reducing compliance costs should generally be eliminated.
7See Reporters’ Study at 101-123 (proposal 3-2).
future disparities in the tax rates applicable to individuals and corporations.\(^\text{12}\) It would give lawmakers greater flexibility to reduce corporate income tax rates to respond to cross-border business considerations—an issue primarily affecting public corporations.\(^\text{13}\)

2. Recognition of gain by a passthrough entity on distributions of property.\(^\text{14}\) The discussion draft generally provides for the recognition of any gain realized by a passthrough entity on the distribution of property to an owner of the entity. The transaction would also be a taxable event to the owner. In general, an owner would recognize gain equal to the excess of the value of any property received over the owner’s basis in the passthrough entity immediately before the distribution (after taking account of any basis adjustment resulting from the passthrough of the gain recognized by the entity in the distribution). In the case of terminations of the owner’s interest in the entity, the owner would also recognize any loss realized or be entitled to a suspended loss that could be recognized at some point in the future. In very general terms, these rules are the same as those currently applicable to property distributions by S corporations.

I support this proposal, which is generally consistent with recommendations contained in the Reporters’ Study.\(^\text{15}\) The nonrecognition of gain or loss in a property distribution has been a significant source of abuse in subchapter K, as evidenced by the series of piecemeal changes that have reversed the nonrecognition result in a number of transactions. The resulting rule structure contributes importantly to the complexity of subchapter K.\(^\text{16}\) Adoption of this single proposal in the discussion draft as an amendment to subchapter K would be a meaningful step toward accomplishing the committee’s dual goals of simplification and reform.

It is commonly argued that nonrecognition treatment of a transaction is appropriate to overcome concerns about lack of liquidity, valuation uncertainties, and lock-in. As explained in the Reporters’ Study, however, none of these reasons would appear to justify the breadth of the nonrecognition result permitted in subchapter K.\(^\text{17}\) Nonrecognition may also be proper in limited cases such as for transactions that do not produce any meaningful change in substance,\(^\text{18}\) are involuntary,\(^\text{19}\) or create potential for abuse.\(^\text{20}\) Here again, these limited reasons would not explain the scope of nonrecognition currently allowed in subchapter K.

Despite many restrictions, the current tax treatment of partnership distributions still permits unjustified tax advantages in some circumstances. The key flaw in the rules is the permissible shifting of a taxpayer’s basis from one property interest to another. This shifting is generally necessary to ensure that any gains realized but not recognized in a distribution are preserved for future recognition. However, the shifting does not take adequate account of differences in a taxpayer’s economic objectives regarding the two property interests. For example, basis shifted from property X to property Y may produce a net tax advantage if a taxpayer intends to dispose of Y but not X. These and other unjustified advantages result in wasteful planning and have been previously curbed by Congress.\(^\text{21}\) A recognition rule in the case of distributions by businesses taxed under subchapter K would go far toward eliminating these advantages, simplifying the rule structure, and reducing compliance costs.

A witness at the recent subcommittee hearing on passthrough entity tax issues opposed the discussion draft’s proposal on distributions in part because “it is beyond debate that in many cases, [the distribution proposal] will result in the taxation of non-economic gains.”\(^\text{22}\) In support, the witness offered the following example:

To illustrate, assume that Partner C is a 50 percent partner in a partnership that has property with a $200 value and a $0 adjusted tax basis. Partner C has a $0 adjusted tax basis in

\(^\text{12}\) An alternate proposal, if nonpublic businesses are allowed to remain in subchapter C, is to repeal the graduated structure of the corporate income tax rates. This solution is still not completely satisfactory if the single corporate income tax rate is markedly less than individual income tax rates.


\(^\text{14}\) See Technical Explanation at 50-51.


\(^\text{16}\) For a description of the principal inadequacies of current law, see Reporters’ Study at 220-234 and 273-299.

\(^\text{17}\) Id. at 234-245.

\(^\text{18}\) An example would be some transactions currently qualifying under sections 351 or 332.

\(^\text{19}\) See section 1033.

\(^\text{20}\) See sections 267 and 1041.

\(^\text{21}\) See section 1031(f). For examples of tax-advantageous basis shifting and other remaining problems under current law, see Reporters’ Study at 230-234 and 278-299.

The example does not provide information about the outside basis of the holders of the remaining 50 percent interest in the partnership. It appears, however, that there may be as much as $200 of economic gain not yet realized before the transaction — the value of the partnership’s property in excess of its adjusted basis in the property.24 Thus, the assertion that the transaction under the discussion draft results in the taxation of $25 of “noneconomic gain” does not appear to be correct. The issue presented by the draft’s proposal concerns the timing of the taxation of economic gains that have already accrued. The question is whether a distribution is the proper time to tax those gains.

In addressing the timing issue, it should be noted that the transaction in the example carries out an exchange between Partner C and the other partners. C receives the property distributed in exchange for a portion of his interest in the remaining assets of the partnership. In general, an exchange of property interests is a taxable event to both parties. The question for the committee is whether that general outcome should be reversed if the exchange is effected through a partnership distribution.25

It should also be noted that in many instances under current law, the transaction illustrated in the example may already be a taxable event. If the transaction results in a change in the partners’ shares of the ordinary-income items of the partnership, section 751(b) is implicated with the consequence that some or all of the partners may have to recognize gain or loss. Given the expansive definition of ordinary-income items for this purpose, recognition of gain or loss is likely to be a reasonably frequent occurrence.26

Section 751(b) is an extremely complicated provision that appears to be often overlooked or misapplied by both taxpayers and the IRS.27 One noted partnership tax expert has estimated that there is a mere 2.5 percent compliance rate with the provision,28 and another has characterized it as “the Achilles heel of subchapter K.”29 The specific consequences of the transaction in the example if section 751(b) is implicated will depend on the extent of the ordinary-income shift. The larger point is that treating such distribution as a taxable event is not unusual if taxpayers are fully compliant with the law. The discussion draft’s proposal simplifies the determination of tax consequences and makes them consistent with the consequences of distributions by S corporations (as well as a sale of the partnership property for $50 cash followed by distribution of the cash to Partner C in redemption of a portion of his interest).30 The proposal should improve compliance and potentially allow repeal of section 751(b) (as well as a host of other provisions).31

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26 See section 751(c) and (d). For purposes of section 751(b), one of the categories of ordinary-income items (inventory items) is taken into account only if, in the aggregate, they are substantially appreciated. See section 751(b)(1)(A) and (3).
27 For a brief explanation of section 751(b), see Yin and Karen C. Burke, Partnership Taxation 239-245 (2013).
28 See Hearings Before the Subcommittee on Select Revenue Measures of the U.S. House Committee on Ways and Means on Issues Relating to Passthrough Entities, 99th Cong., 2d Sess. 56 (1986) (statement of Joel Rabinovitz) (claiming that section 751(b) is probably overlooked in 90 percent of the cases in which it applies, is ignored in another 5 percent of the cases because the cost of compliance would be so high, and is misapplied by the IRS in another 2.5 percent of the cases).
30 Under the discussion draft’s proposal, Partner C generally obtains a fair market value basis in the property distributed.
31 The discussion draft appears to retain the substance of section 751(b) in addition to taxing entities on the distribution of appreciated property. The two provisions do not completely overlap. For example, a non-pro-rata cash distribution by a partnership would not trigger any entity tax consequences under the discussion draft’s distribution proposal, yet it might shift the ordinary-income shares of the partners and result in tax consequences under current section 751(b). In light of the compliance difficulties with section 751(b), the committee should consider whether and to what extent section 751(b) should be preserved if the discussion draft’s proposal on

(Footnote continued on next page.)
Finally, even if the committee is inclined to make no major change to the partnership distribution rules, it should consider redrafting the statute to provide for a general rule of recognition in the case of distributions (combined with selective nonrecognition exceptions). The view of a partnership distribution being a nonrecognition event remains widely held among taxpayers and their advisers despite the existence of many exceptions that trump the general rule. Reversing the default rule in the statute should improve compliance by forcing taxpayers to identify a specific exception before claiming a nonrecognition result. This statutory revision would also give the committee an opportunity to return to first principles and determine precisely which distribution transactions should appropriately qualify as nonrecognition events.

If the committee follows this process, I encourage it to scrutinize carefully partnership mergers, divisions, and other restructuring transactions before granting any of them nonrecognition treatment. The almost 100-year history of the acquisitive reorganization rules in subchapter C is marked by a series of incremental changes that gradually broadened the nonrecognition exception. The end result is an extremely complicated and largely incoherent set of provisions. The divisive reorganization rules in the corporate area have a similarly blemished history. Their original conditions — intended to prevent a specific tax avoidance technique (the bailout of corporate earnings without a dividend tax) — remain in the statute, even though the function of the law today is altogether different (to prevent avoidance of General Utilities repeal and nonrecognition treatment of some disguised sales). It would be a tremendous shame if, following adoption of the discussion draft’s proposal, the next 100 years were spent recreating similar bodies of law in subchapter K. Far better for the committee to focus on trimming back and eliminating portions of corporate reorganization law that no longer serve useful policy goals.

3. Restrictions on the allocation of distributive shares. The discussion draft imposes restrictions on the allocation of tax items of a passthrough entity. All items would be divided into three categories: ordinary items, capital gains rate items, and tax credits. An owner would be entitled to only a single distributive share of all items belonging to any given category. Owners, however, could claim different distributive shares for each of the three categories of items. In general, distributive shares would be determined by the ownership agreement but would have to be consistent with the owner’s “economic interest” in the passthrough entity (after taking into account all of the facts and circumstances).

I am very sympathetic to the goals of this proposal because the partnership allocation rules are badly in need of reform. Because the proposal is not developed very far, however, it is difficult to determine whether it would represent an improvement over current law. For example, it is unclear how an owner’s economic interest in each of the three categories of items would be determined, how it would compare with current law’s “partner’s interest in the partnership” test, and whether something like capital accounts would be required.

The committee should also be aware of a possible conceptual problem with any attempt to restrict the flexibility of tax allocations by passthrough entities. The discussion draft’s articulation of an economic interest test appears to be in harmony with the general principle under current law that allocations of tax items must be consistent with allocations of the corresponding economic item. If that is correct, however, any restriction imposed on the allocation of tax items must necessarily result in the same restriction being applied to the allocation of the economic item. This creates a significant risk of the “tail wagging the dog,” in which the tax law dictates how parties must carry on their economic affairs.

To illustrate, suppose two partners form a real estate partnership to invest in various parcels of land for ultimate sale to developers. Assume that any gains or losses of the partnership would qualify as capital gain or loss and would thus all fall in the “capital gains rate items” basket. The partners disagree on the economic prospects of some parcels identified for possible purchase, and attempt to overcome their disagreement by making disproportionate allocations of gains and losses from various parcels to the partner who is more bullish about the
parcel's prospects. For example, although the partners generally consider themselves to be equal owners, they agree to allocate 70 percent of any gain or loss from one parcel to one partner, and 70 percent of any gain or loss from another parcel to the other partner.

It appears that these different allocations to a given owner of tax items belonging to the same basket would not be permissible tax allocations under the discussion draft's proposal. If so, it also must mean that the economic sharing arrangement is impermissible, or else there would be a deviation between the tax and economic allocations. However, the economic sharing arrangement may be the most efficient way for the partners to reach agreement on their investment objectives. The committee should consider carefully whether the tax law should impose this type of restriction on the formation of economic agreements.

4. Five-year recognition period for purposes of subchapter S built-in gains tax. The discussion draft proposes a permanent five-year recognition period (in lieu of the general 10-year rule) for purposes of section 1374.

The purpose of section 1374 is to protect the corporate tax on gains accrued by a C corporation that are ultimately realized and recognized by an S corporation. If the committee is serious about protecting this tax, there is no theoretical justification for any limitation on the length of the recognition period, let alone its reduction from 10 to five years. Obviously, the shorter the period, the more likely taxpayers will elect to use subchapter S strategically in order to avoid the corporate tax. Prior experience under subchapter K has suggested that a five-year waiting period may not be long enough to discourage strategic behavior of that sort.

There is, however, a possible flaw in existing section 1374. When it applies, taxpayers must immediately bear two taxes on the gain subject to the rule. The S corporation must pay tax on the gain (at the highest corporate tax rate), and the same amount of gain (less the section 1374 tax) is passed through to the shareholders who must also pay tax on it. This is in contrast to what would have happened if the gain had been realized and recognized by the C corporation that accrued the gain. In that case, the C corporation would have paid tax on the gain, but the “second,” shareholder-level tax, would have been deferred until a realization event to the shareholder. The immediate imposition of two taxes is presumably the reason why S corporations apparently monitor closely their recognition of any section 1374 built-in gains. It also presumably explains the intensity of taxpayer interest in reducing the length of the recognition period.

Correction of the flaw in section 1374 provides a possible compromise solution for the committee to consider in lieu of the proposed reduction of the recognition period. First, the law could be revised to remove any limit on the recognition period in section 1374. In addition, however, when section 1374 applies, only one tax would be imposed (and the second tax would be preserved for future recognition). This result could be easily implemented by not allowing any shareholder basis adjustment to the amount of built-in gain recognized under section 1374. The single tax imposed could be the normal, shareholder-level tax under subchapter S if the built-in gain is passed through to the shareholders (but with no basis adjustment resulting from the passsthrough). Alternatively, since the tax that the law is protecting is the corporate tax, it may be more appropriate to impose the single tax on the S corporation (at the highest corporate tax rate, as under current law). In the latter case, there would be no passthrough of the gain to the shareholders (and no basis adjustment). Any shareholder-level tax consequences would thus await a realization event to the shareholder, the same result as if the gains had been recognized by the C corporation.

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35 See Technical Explanation at 12-14.
36 See sections 704(c)(1)(B) and 737(b)(1) (increased waiting period from five to seven years to prevent strategic behavior). The discussion draft would eliminate both seven-year limitations. See Technical Explanation at 32.

37 See section 1366(f)(2).