Reforming and Simplifying the
Income Taxation of Private Business Enterprises

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November 15, 2000

Summary of paper

Under current law, many private businesses, no matter what their organizational form or characteristics, have the choice of being taxed under one of three possible income tax regimes. In general, they can be taxed under the set of rules traditionally reserved for corporations (subchapter C), for partnerships (subchapter K), or for certain closely-held corporations (subchapter S).

In this paper, we argue that there is no policy justification for permitting firms to continue to choose among these three sets of rules, and that the existence of the choice unnecessarily complicates the law for both taxpayers and the IRS. In general, we recommend that the choice be narrowed to two -- subchapter K and subchapter S -- with the options being reconfigured somewhat to make them more consistent with one another and more rational. Subchapter S is preserved and liberalized because it offers a simplified method of taxing the income of private businesses. We would reserve this option for those firms that are owned exclusively by individuals and that have straightforward economic arrangements, two characteristics that make such firms less susceptible to tax advantage and abuse, and therefore less in need of complicated anti-abuse protections. In general, all other firms, including any eligible firms not choosing the subchapter S option, would be taxed under subchapter K as modified by selected reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform and simplification of the tax laws. Too often, those objectives are in conflict with one another. While many details need to be carefully considered, we believe that the recommendations outlined in this paper have the potential for achieving that happy combination.

This paper summarizes the principal recommendations of an American Law Institute Reporters’ Study prepared by the authors on this topic. Interested readers should consult the Study for the complete set of proposals and a fuller discussion of the issues. Copies are available from the ALI (800-253-6397).
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Under current law, many private firms, no matter what their organizational characteristics, are entitled to choose among subchapters C, K and S of the Internal Revenue Code for their applicable income tax rules. In this paper, we recommend that current law be reformed and simplified by treating generally all private business firms as conduits for income tax purposes. Conduit taxation disregards the existence of the firm for tax purposes as much as possible; the rules of subchapter K are the closest approximation of conduit taxation in this country. In addition, because conduit taxation, as manifested by existing subchapter K, can be extremely complicated, and because needed reforms may only make it more so, we propose that the recommendation be implemented through a “two-track” approach. A simplified set of conduit tax rules would be used by certain private firms unless they elect otherwise, and a regular set of conduit rules would be used by all others. In general, the simplified rules would be available only to firms that are owned exclusively by individuals and that have surrendered some flexibility in their economic arrangement. The simplified rules will resemble a liberalized version of current subchapter S, whereas the regular conduit rules will consist of the subchapter K rules as modified by selected, proposed reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform and simplification of the tax laws. Too often, those objectives are in conflict with one another. While many details need to be carefully considered, we believe that the recommendations outlined in this paper have the potential for achieving that happy combination.

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The paper is organized as follows. Part I briefly summarizes the defects of current law. Parts II and III address why private firms should generally be treated as conduits for tax purposes and why a two-track approach for carrying out that recommendation is appropriate. Part IV then provides the principal details regarding how the two-track approach would be implemented. Part V contains our conclusion.

I. Defects of Current Law.

At present, many private business enterprises, no matter what their organizational characteristics, are provided with an explicit choice regarding how the income of the firm is taxed. For firms engaged in general business activities, the choices under the “check-the-box” regulations of current law are generally the rules contained in subchapters C, K, and S of the Internal Revenue Code. Although incorporated firms are currently not provided with the same choice as unincorporated ones, an unincorporated business with precisely the same characteristics as an incorporated firm is given that choice. Hence, it seems only a matter of time before all private firms, incorporated and unincorporated, will be afforded the same explicit choice of taxation schemes.1

This state of affairs is inconsistent with the historical development and substantive rules of subchapters C, K, and S. Each set of rules -- most clearly in the case of subchapters C and K and less obviously in the case of subchapter S -- was designed to apply to a particular form of business organization with specific characteristics. Yet, adoption of the check-the-box regulations reflects a policy determination generally to disregard business organization form and characteristics for income tax purposes. Given that, it is difficult to understand why private firms are nevertheless allowed a choice regarding how they are taxed, and why they are given the particular choices that they are.

If the three sets of rules produced more or less the same tax consequences in most situations, the choice among them might not be especially significant. But that is not the case. In any given situation, subchapters C, K or S may provide an advantageous tax result for particular taxpayers. For example, under subchapter C, the firm (and not the owners) is taxed on the business income when it initially arises and the owners are taxed on the same income when it is distributed to them. The possibility of double taxation, and the inability to net business income and

1Public firms are not provided the same choice by reason of section 7704 of the Code. See Treas. Reg. § 301.7701-2(b)(7). In this paper, we assume continuation of the general policy decision to treat public and private firms differently for tax purposes, and we offer no recommendation regarding how public firms should be taxed.
losses with other tax items of the owners, is ordinarily unattractive to taxpayers. On the other hand, for many private subchapter C firms, the business income is initially taxed at graduated rates unrelated to the ability to pay of the owners. In addition, the second tax of such firms may be deferred or eliminated altogether, or may be levied at preferential rates. In combination with the graduated tax rate schedule, it is therefore possible for business income to be taxed more favorably under subchapter C than either subchapters K or S. Private firms may also select subchapter C because it allows the future conversion to public status to be without tax consequences, and entitles the firm to other special tax provisions.

In contrast, subchapters K and S each offers a form of conduit taxation under which the firm is not taxed; instead, business income and losses are passed through to the owners of the firm. Thus, double taxation is avoided and owners are permitted to net any business income and losses with their other tax items. On the other hand, the owners must pay tax at their tax rates on the business income as it arises. Obviously, these features of conduit taxation may or may not be advantageous, depending upon the applicable tax rates and other factors. As between subchapters K and S, there are a number of significant tax differences. Under subchapter K but not subchapter S, (1) firms may specially allocate their tax items among their owners, (2) entity-level debt may be included in the basis of the owners in their ownership interests, and (3) the inside basis of a firm’s assets may be adjusted upon the death of an owner, a transfer of ownership interests, or a distribution from the firm. In addition, a contribution or distribution transaction between the owners and the firm more likely results in the nonrecognition of gain or loss under subchapter K than subchapter S. On the other hand, only subchapter K firms are subject to a series of complicated rules designed to prevent tax advantages in selected situations. Further, S corporations, like C corporations, can convert to public status without tax consequences and can participate in a tax-

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2See I.R.C. § 11(b).  
3Compare I.R.C. § 704(a) and (b) with §§ 1366(a)(1), 1377(a).  
4See I.R.C. § 752.  
5See I.R.C. § 754.  
6Compare I.R.C. § 351 with § 721 and §§ 1366, 302, 331, 311, and 336 with §§ 731, 704(c)(1)(B), 737, 707(a)(2)(B), and 751(b).  
7See, e.g., I.R.C. §§ 704(c), 707(a)(2) and (b), 724, 731(c), 732(c), 735, 737, and 751. Subchapter S firms are, however, subject to the collapsible corporation provisions of section 341. See I.R.C. § 1371(a).
free reorganization with a C corporation. Subchapter K firms cannot participate in reorganizations and, when they go public, the transaction may or may not be wholly tax-free. After taking into account all of the differences, subchapter S is usually less advantageous than subchapter K but in certain cases, it may be more advantageous.

The elective tax treatment undermines both equity and efficiency objectives for the income tax. Although in theory, similarly situated businesses have an equal opportunity to be treated in the same tax-advantageous manner under current law, the practical reality is probably to the contrary, due to disparities in the quality of advice the businesses receive. By permitting such disparate tax choices without any apparent underlying, conceptual foundation, current law simply provides a tax benefit for the well-advised and a trap for the ill-advised. There is no particular policy reason why the taxation of private business firms should result in the minimization of tax liabilities for only the well-advised. Moreover, current law violates vertical equity norms. By giving well-advised private business owners a range of tax liabilities to choose from, current law by definition cannot impose the “proper” level of tax on them based upon vertical equity principles.

The elective nature of current law fosters inefficiency in several ways. First, not all businesses are provided with the same tax benefit of being able to choose their tax liability within a range of options. Neither public firms nor sole proprietors, for example, are provided with the same degree of flexibility in determining the amount of their income tax liabilities. Thus, current law may distort the economic decisions of firms near the boundary of those eligible for the tax choice, thereby potentially causing deadweight losses. Indeed, private firms were already generally taxed more favorably than either of the other two types of businesses prior to the check-the-box regulations; the new choice for private firms simply tilts the tax scales further in their favor.

Second, as previously noted, not all eligible firms may make the optimal tax choice due to a variety of factors. But if, for whatever reasons, firms differ in their access to the tax minimization techniques, then allocative distortions across firms may result.

Finally and most importantly, current law is unnecessarily complicated and costly. To minimize tax burdens, businesses must consider the consequences of three possible operating rule systems on their anticipated business activities and learn to comply with the rules selected. The IRS must administer and give oversight to the three different systems. Further, the planning, compliance, and

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8See I.R.C. § 1371(a).
administration costs are ongoing in that businesses may have the opportunity to change their choice of rule structure as their business activities evolve or as other aspects of the law change. Reducing the number of choices should simplify the law and improve its efficiency by decreasing transactions costs.

In conclusion, the current system of taxing the income of private business enterprises has evolved into one that is inconsistent with its historical roots and violates important tax policy objectives. With the link between taxes and organizational form broken, there is no longer any clear justification to maintain all three systems of taxation. The next part of this paper describes why all private firms should generally be treated as conduits for income tax purposes.

II. Taxation of Private Business Firms as Conduits.

The two basic approaches to taxing the income of a firm are conduit and entity taxation. Under conduit taxation, the firm is not treated as a taxpayer separate and apart from its owners. Rather, the firm is transparent for tax purposes; its various tax items pass through to the owners of the firm, the real (and only) taxpayers in interest. Under current law, both the partnership tax rules of subchapter K and the subchapter S rules for certain closely held corporations implement a version of conduit taxation, with subchapter K being a closer approximation of the approach.

In contrast, under entity taxation, the firm is treated as a taxable entity in its own right. Current subchapter C, under which the firm is taxed on business income as it arises and then the owners are taxed again upon a distribution of profits to them, is an example of entity taxation. However, entity taxation need not result in double taxation. For example, in 1992, the Treasury Department recommended exploration of an approach, termed the Comprehensive Business Income Tax (CBIT), that would subject the income of all business entities (except for extremely small ones in terms of gross receipts), including sole proprietorships, partnerships, corporations, and firms organized in other business forms, to a single, comprehensive entity-level tax, with generally no further income tax consequences at the owner level. The Treasury estimated that CBIT would produce greater welfare gains than any other form of corporate integration, including Treasury’s version of partnership-style integration.9

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Another example of an entity tax approach is the imputation credit system of integration recommended by the ALI Reporter’s Study.\textsuperscript{10} Under that approach, an entity-level tax on business income would be imposed pending a distribution, at which point there would be a reconciliation of the entity and owner-level taxes to prevent double taxation and to insure that the income is ultimately taxed at the owner’s tax rate. Thus, undistributed income would be subject to an entity tax and distributed income would be temporarily subject to one. Business losses would not pass through to owners. Although the ALI Reporter’s recommendation only addressed the taxation of corporations, the approach could in theory be made applicable to all business firms, no matter how they are organized.

The following sections compare the advantages and disadvantages of conduit and entity taxation. To provide a fair comparison, the discussion assumes that the entity tax system would be implemented without imposing double taxation. Although the choice is a very close one, we conclude that all private firms generally should be taxed in accordance with the principles of conduit taxation.

A. Equity and efficiency. -- Tax policy principles of equity and efficiency both seem to favor conduit over entity taxation of a firm. An equity argument begins with the proposition that people, and not entities, pay taxes, and that people should pay income taxes in accordance with their ability to pay. Two important objectives relating to the taxation of business income flow from this proposition. First, the owners of a firm should be entitled to net their income, deductions, and losses from other sources with their share of the firm’s tax items in order to determine their overall ability to pay. Second, the resulting net tax items of the owners, including their share of the firm’s tax items, should be taxed at rates consistent with their ability to pay. By disregarding the entity for tax purposes and taxing owners directly on their share of the entity’s tax items, conduit taxation potentially accomplishes each of these two goals.

In contrast, entity taxation does not satisfy either goal. A single entity tax rate, by definition, cannot be made consistent with the ability to pay of the owners in any situation where the owners have differing abilities.\textsuperscript{11} In addition, entity taxation limits the ability of owners to net their tax items with their share of the firm’s tax items, thereby precluding a proper determination of their ability to pay.

\textsuperscript{10}See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES -- REPORTER’S STUDY OF CORPORATE TAX INTEGRATION BY ALVIN C. WARREN (1993) [hereinafter ALI REPORTER’S INTEGRATION STUDY].

\textsuperscript{11}This statement is true even under a system like the ALI Reporter’s Study where the entity tax plays a withholding role. Pending a distribution, taxation of the business income is generally taxed at the wrong rate.
For example, owners would not be able to utilize any available deductions to reduce their share of the firm’s income in calculating their taxable income. Similarly, owners could not use their share of a firm’s losses to reduce their income from other sources. In short, entity taxation is not consistent with equity principles for the income tax.

An efficiency argument in favor of conduit taxation is that it conforms more closely than entity taxation to how proprietorships are taxed and therefore minimizes distortions in the choice of business form. This is because sole proprietors are taxed directly on their proprietorship income as it arises and are entitled to deduct currently any losses of the enterprise as they arise. The business itself is not subject to a separate federal income tax.

Of course, to conform to entity taxation, it would theoretically be possible to treat a proprietorship as a taxpayer separate from its proprietor. As noted, the 1992 Treasury report made exactly that recommendation. But such a system would be very problematic, depending upon the applicable tax rate structure.

For example, suppose all proprietorships were treated as taxpayers separate from their proprietors and made subject to a flat 30 percent income tax rate. In that case, proprietors in marginal tax brackets higher than 30 percent would be encouraged to redesign their economic arrangements to generate proprietorship income for themselves rather than wages or other income. Meanwhile, proprietors in marginal tax brackets less than 30 percent would be encouraged to employ the opposite strategy. For instance, they might increase the level of deductible salary payments paid by their proprietorship to themselves. Given the absence of arm’s length dealing between a proprietor and proprietorship, it would presumably be extremely difficult for the IRS to monitor and prevent purely tax-motivated arrangements of this sort.

Taxing the proprietorship’s income in a progressive manner would not improve matters because there still would not be any necessary correlation between the proprietorship’s tax rate and the proprietor’s ability to pay. The proprietor may well have income, deductions, or losses from other sources which would need to be taken into account, along with the proprietorship income, to determine the proprietor’s ability to pay. It is for this same reason that the graduated tax rate structure under which many corporations are taxed today does not carry out any vertical equity objective.

Assuming, then, that proprietors are to continue to be taxed directly on their business income and losses, it follows that businesses with more than one owner should likewise be taxed as conduits. If the proprietorship is not treated as a separate taxpayer, it is difficult to see why, say, a two-person general partnership
should be so treated. Further analogies then might suggest that no business firm should be separately taxed. As an economic matter, if proprietors are taxed directly on their proprietorship income but partnerships (and not the partners) are taxed on the partnership income, then the tax system will have created an undesirable barrier against or inducement in favor of the pooling of resources via a partnership.

True, the state law characteristics of a proprietorship may be different from those of many other business forms. Unlike a proprietorship, other forms of business organization are treated for a number of state law purposes as legal entities separate from their owners. But certain of these state law characteristics are only default positions, supplying a rule in the absence of any contrary agreement by the parties. Thus, they do not provide a very solid basis for determining the manner in which a firm should be taxed. Moreover, the clear message of the check-the-box regulations is to ignore state law differences among private business entities in making that determination. At least for tax purposes, then, it would seem that proprietorships and other private business firms should be treated as similarly as possible. Conduit, and not entity, taxation of private firms accomplishes that goal.

In formulating its 1992 recommendation, the Treasury Department articulated a different efficiency consideration, one that it believed constituted a rationale for entity taxation:

Assuring that corporate income is taxed once, but only once, does not require that corporate income be taxed at individual rates, however. Attaining a single level of tax -- with the most significant efficiency gains we project from any system of integration -- can be achieved with a schedular system in which all corporate income is taxed at a uniform rate at the corporate level without regard to the tax rate of the corporate shareholder....

... Economic efficiency suggests that all capital income should be taxed at the same rate. Accordingly, we place less emphasis than some advocates of integration on ... trying to tax corporate income at shareholder tax rates ....

But to the extent this rationale is based on the efficiency of taxing all income, whether from capital or labor, in a uniform manner, it may conflict with equity objectives of the income tax, which may dictate that all income should not be taxed at the same rate. If, on the other hand, the rationale is based on the more
limited proposition that it is efficient to tax only *capital* income uniformly, the 
equity objection is still potentially present, although less severe. Moreover, an 
entity tax approach may not be a particularly effective way of accomplishing the 
more limited goal. The basic problem is that various income-shifting devices, 
especially available to the owners of private, closely held firms, easily permit 
taxpayers to muddy the distinction between capital and labor income. Some 
business income of a firm may in reality be income from the labor of the firm’s 
owners, and some labor income may in reality include capital income from 
investment in a firm. Hence, taxing a firm’s income at the same rate may not be 
an effective method of taxing all capital income, and *only* capital income, in a 
uniform manner.

In summary, equity considerations clearly favor conduit over entity 
taxation. Efficiency considerations are a little more mixed. Given how 
proprietorships almost surely must be taxed, conduit taxation minimizes distortions 
in the choice of business form. Entity taxation promotes greater uniformity in 
taxation, but only through a potential conflict with equity objectives of the income 
tax. And entity taxation may not be an effective way of taxing only capital income 
uniformly, if that is the efficiency objective.

B. Compliance and administration. -- Considerations of tax compliance 
and administration provide a preference for entity taxation over conduit taxation. 
One important advantage of the former is that it potentially reduces the extent of 
taxpayer involvement in the taxation of business income. The firm, rather than the 
owners, would be the focal point for the Treasury’s tax collection efforts in an 
extity tax system.

Entity taxation also potentially facilitates a simpler determination of tax 
liability by permitting the tax consequences of a transaction to follow its form. For 
example, suppose a business firm earns $300 in taxable profits in a given year. 
How is the income tax on that $300 to be determined? Under entity taxation, the 
answer is straightforward -- the $300 is taxed to the firm at some rate applicable 
to the firm. In contrast, under conduit taxation, the $300 must be included in the 
tax bases of the owners of the firm and taxed to such owners. But how much 
should be allocated to whose base? The difficulty in answering that question is the 
fundamental problem of any conduit tax system.

The source of the difficulty is the fact that income and other items realized 
by many business entities are treated under state law as belonging to the entity and 
not to the owners. The receipt by the owners of the entity’s income, for example, 
may arise only upon a distribution from the entity. Yet consistent with basic 
inecome tax principles, tax reporting of the income cannot await a distribution. 
Someone must include it in that person’s tax base when the income arises. Thus,
under conduit taxation, if there is no distribution but the income is retained by the firm, there must nevertheless be a current allocation of the income among the owners to permit them to report currently their share of it. In short, entity taxation follows the form of the transaction by taxing the firm, the nominal earner of the profits. Conduit taxation, in contrast, requires a determination of substance -- which owner has really obtained the economic benefit of the profits? There must be identified an economic baseline against which the validity of the tax allocation can be tested.

Unfortunately, despite many complex requirements contained in the Treasury regulations implementing conduit taxation, the necessary economic baseline is indeterminable. We simply do not know how the owners would have shared undistributed income earned by a firm, for example, had there in fact been a distribution of that income in the year it was earned. Indeed, in many cases, the owners themselves do not know how they would have shared the income, because their “deal” extends far beyond the economic outcome of a particular year. But without that piece of information, it is not possible to fashion a workable rule that can ferret out purely tax-advantaged allocation arrangements under a conduit model of taxation. Conduit taxation rejects form and requires a determination of substance, yet there is no clear way of ascertaining what the substance is.

The discussion thus far would seem to have exposed major flaws in both conduit and entity taxation. Although the latter would tax the business income at the wrong rate and prevent netting of the owner’s tax items, the former cannot provide assurance that the business tax base is taxed to the right owner. So which approach is preferable?

To help answer that question, it is worth considering in a little more detail some of the potential compliance and administration problems presented by an entity tax system. As previously noted, an entity tax approach offers the advantage of taxing a transaction in accordance with its form. An “inside” event, such as a firm’s earning of profits, is generally taxed “inside” the firm (i.e., the firm pays tax on the profits); the profits need not be allocated and taxed “outside” the firm (i.e., to the owners of the firm). Somewhat surprisingly, however, entity taxation raises some of the same difficult implementation issues as conduit taxation. In certain important situations, “inside” events have tax ramifications “outside” the firm (i.e., to the owners), and “outside” events generate tax consequences “inside” the firm. Thus, mere form cannot always be followed; in an entity tax system, some determination of substance is also necessary.

To illustrate, consider a scheme in which business income is taxed once at the entity level with distributions of already taxed income then being tax-free to the owners of the firm. Consider just the single issue of how the gain or loss arising
upon a transfer of the ownership interests of a firm should be taxed under such a system.

In theory, any gain or loss might reflect some combination of (1) income accumulated by the firm that has already been subject to the entity-level tax, (2) accumulated preference income that has escaped the entity-level tax, and (3) unrealized gains and losses of the firm (including the value of the firm’s projected profits and losses).13 Neither the fully taxed income nor the preference income should be taxed again upon the transfer of ownership interests, assuming there is a policy decision to pass through preferences. Presumably, however, there should be a tax on the gain or loss representing the unrealized entity-level gain or loss. How should the rules be designed to tax this last element while not taxing the portion of the gain or loss representing accumulated, previously taxed income or preference income?

One rough method of accomplishing that end, suggested by both the Treasury Department and the ALI Reporter in their integration proposals, is to provide outside basis adjustments equal to the fully taxed and preference income (assuming passthrough of preference income) not distributed by the firm.14 Analytically, the procedure, termed a “dividend reinvestment plan” or “DRIP” by the Treasury, would allow firms to retain their earnings but to declare constructive distributions followed by constructive reinvestments of those amounts back to the firm. The distributions of previously taxed (or preference) income would be tax-free to the distributees, and the reinvestments would produce the desired increase in outside basis. At least in theory, if all retained earnings were made subject to a DRIP, then gain and loss upon transfer of ownership interests would reflect only unrealized gains and losses at the firm level.

A DRIP, however, is nothing more than an allocation of undistributed income among the owners of the firm, the core requirement of a conduit tax system. Although the ramifications of a DRIP under an entity-level tax would be less significant than in a conduit system because the income being allocated under the DRIP would already have been subject to tax, nevertheless the practical difficulties with the allocation would be the same. If a set of rules could be developed to specify the appropriate outside basis adjustments for private business firms with tiers of owners and preferential, contingent, and inchoate ownership interests, among other things, those same rules could be utilized to implement a

13The possibility of inflationary gains is irrelevant to this discussion and is therefore ignored.

14TREASURY INTEGRATION REPORT, supra note 9, at 87-88; ALI REPORTER’S INTEGRATION STUDY, supra note 10, at 126-27 (proposal 5).
conduit tax system. In short, implementing an entity tax system introduces some of the same inside/outside coordination problems that plague a conduit tax system.

C. **Summary and conclusion.** The choice between conduit and entity taxation is a very close one. The conduit approach is clearly favored based on equity considerations. The question is a little closer if efficiency is taken into account and closer still after compliance and administration issues are considered. Perhaps the deciding factor is the greater transitional cost of an entity tax approach. A conduit approach is already in effect for those firms currently taxed under either subchapters K or S. In contrast, an entity tax approach imposing only a single level of taxation on business income would represent a new system for all firms. Accordingly, we recommend that as a general rule, a conduit tax approach be adopted for the income taxation of private business firms. The starting point should be the rules of subchapter K, the closest approximation to conduit taxation under current law.

III. **The Case for an Alternative (and Simplified) Version of Conduit Taxation.**

In this part, we discuss why two versions of conduit taxation should be developed for private business firms -- a “regular” version (resembling a reformed subchapter K) and an alternative, “simpler” version (resembling a liberalized subchapter S). In the next part, we provide the principal details of how this two-track recommendation should be implemented, including a description of which firms would be eligible to use each set of rules. In this part, we explain the rationale for developing an alternative, simplified conduit version for a subset of private firms.

In the ideal, all private firms should be taxed in the same way. Indeed, the basic criticisms of current law described in Part I center around the inequity and inefficiency of maintaining multiple taxation schemes. Multiple systems also make the law more complicated, introduce coordination problems, and increase the number of transitional issues.

On the other hand, 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 has followed this route many times in the past, such as in the development of the “simple” and “complex” trust rules, the availability of

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the short and shorter forms of the basic individual income tax return, and the exempting of large categories of taxpayers from certain administratively onerous rules.\footnote{Sec., e.g., I.R.C. §§ 55(e) (exempting certain small corporations from alternative minimum tax), 263A(b)(2)(B) (exempting certain property of certain small businesses from uniform capitalization rules), and 448(b)(3) (allowing certain small businesses to use the cash method of accounting for tax purposes).}

Whether two or more tax systems should be developed for the taxation of business income depends upon the resolution of several difficult questions, including (1) whether a simplified tax system for a meaningful subgroup of the population can be devised; (2) whether use of the simplified system would reduce compliance costs and produce other gains for the subgroup for whom the rules are designed; and (3) whether such gains, if any, exceed the costs incurred in maintaining two systems rather than one. Obviously, none of these questions can be answered in the abstract. An alternative system must be offered before an analysis of any of these questions can even begin.

The question, therefore, is whether there is sufficient evidence to support an attempt at developing an alternative, simplified system for a subgroup of private business firms. Is the case so overwhelming against the need for such an option that its development would surely be futile? Although the evidence is not nearly as complete as desired, it appears to be sufficient to warrant at least initial consideration of such a system.

Consider first the central difficulty of any conduit tax system -- the allocation of the firm’s tax items among the owners of the firm. Under subchapter K, an allocation must have “substantial economic effect” to be respected. The complex and burdensome manner in which the regulations interpret that term is already legendary, with the result that there may be a high degree of taxpayer noncompliance with them. For example, taxpayers might fail to establish and utilize mandated procedures, such as the maintenance of book capital accounts in a particular manner, or erroneously omit certain boilerplate provisions in their partnership agreements. Or, taxpayers might not actually follow through on provisions in their agreements mandated by the tax authorities, such as the requirement to make liquidating distributions in accordance with the capital account balances of the partners. Taxpayers may also flunk one or more of the subjective standards contained in the regulations.

To a handful of partnership tax experts, compliance with the allocation provisions of subchapter K may be largely second nature by now. But surely that
is not the proper standard to use in evaluating the impact of the rules. Probably a more accurate assessment of current practice is reflected in the comment that:

[g]arden-variety partnerships -- small businesses advised by ordinary lawyers and accountants -- will seldom make allocations that have “substantial economic effect” in the sense in which the regulations use that term.17

If this view is correct, the allocation rules of subchapter K risk being a mere facade, a nice theoretical way of imposing taxes on business income that is not matched by real world consequences to most taxpayers.

It is true that partnerships with very straightforward economic arrangements may have little to be concerned about even if they do not comply with the substantial economic effect requirements. In the event of noncompliance, such partnerships will have their tax items allocated in accordance with the “partner’s interest in the partnership” (“PIP”), which should ordinarily mean the straightforward economic arrangement. But there are two problems with that response to the complexity of the allocation provisions. First, it does little to reduce the compliance burdens of taxpayers. They may continue to try to meet the substantial economic effect requirements; the tax authorities may simply tell them, in effect, “never mind” upon discovering that they did not succeed. Second, reliance upon the PIP default is a risky proposition, the success of which depends upon how straightforward the economic arrangement really is. It would seem preferable to establish upfront the limits of a straightforward arrangement, and then to allow taxpayers who stay within those limits to avoid the burdensome allocation requirements altogether.

The difficulty of a conduit tax system epitomized by subchapter K is not limited to allocations. Many analysts have suggested that there may be widespread disregard of one or more other partnership tax rules because of the inability of firms and their advisors to apply them correctly and of the IRS to administer them. As Judge Raum complained over 30 years ago:

The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field…. Surely, a statute has not achieved “simplicity” when its complex provisions may confidently be dealt with by

17See ALAN GUNN, PARTNERSHIP INCOME TAXATION 44 (2D ED. 1995).
at most only a comparatively small number of specialists who have been initiated into its mysteries. 18

Many, many others have voiced similar concerns.

Furthermore, the partnership tax rules were made even more difficult by the adoption of a general “anti-abuse” regulation in subchapter K. 19 Although there continues to be some disagreement as to the meaning and scope of the regulation, as well as its wisdom and validity, the adoption of the regulation is certainly not a positive indication of the general health of the subchapter K rules. Indeed, some of the commentary published in response to the proposed version of the regulation illustrates examples of transactions meeting the literal terms of the statute and/or regulations yet reaching seemingly nonsensical results.

It is evident that if one were writing on a clean slate, one would not adopt a set of operating rules like subchapter K that first touts their flexibility, 20 then proceeds to restrict that flexibility with a series of highly complex mechanical and sometimes subjective tests, 21 and then overlays on top of those tests a relatively amorphous supertest authorizing the disregard of the consequences of earlier tests despite plain compliance with them. Indeed, the general anti-abuse rule may apparently apply to negate a taxpayer’s successful navigation of other anti-abuse rules adopted to monitor particular types of partnership-related transactions. 22 Something very fundamental must be awry in the basic structure of the rules for the law to have evolved into this unhappy state.

Once again, it is sometimes argued that taxpayers with relatively simple business arrangements are not adversely affected by the many complications of subchapter K. Under this view, subchapter K is flexible enough to be all things to all people: a fairly simple set of tax rules for taxpayers with simple business deals, and a more complex set of tax rules for taxpayers with more elaborate undertakings. Thus, according to this position, there is no need to create a simplified version of conduit taxation.

18 Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964).
19 Treas. Reg. § 1.701-2.
21 See, e.g., Treas. Reg. § 1.704-1, -2, and -3.
It may well be true that many smaller firms already use a simplified version of subchapter K to calculate their income tax liabilities. But if true, that phenomenon may simply be a practical response to the burdensome nature of the partnership tax rules. It is not at all clear that the law actually authorizes such use.

For example, consider a three-person firm that decides to split up. A separation as simple as a cash buyout by the firm of the entire interest of one of the partners may have the counterintuitive results of some ordinary income consequences to the partner who is bought out and a change in the basis of some of the firm’s remaining assets.\(^{23}\) Indeed, according to the IRS, the same results may occur even without an actual distribution to anyone.\(^ {24}\) And if the buyout were complicated slightly by assuming a distribution of property other than cash to the partner being bought out, such as a distribution of a parcel of land to the distributee, the continuing partners as well as the distributee may have either capital or ordinary income or loss from the transaction. The distributee is treated as acquiring the portion of the distribution that is disproportionate to the distributee’s pre-distribution share of such property from the other partners in exchange for other, undistributed property of a different character which the distributee disproportionately surrenders in the distribution.\(^ {25}\) Thus, at least in theory, the complications of subchapter K may well intrude into the common transactions of many simple business arrangements.

Moreover, even if it were true that taxpayers with simple deals and their advisors need not concern themselves with the more complicated portions of subchapter K, the law does not so advise them. Rather, like all private firms, they would at least initially face compliance with the entire panoply of subchapter K rules. In contrast, their task would be simplified if they were provided with an abbreviated set of tax rules with which they had to comply. The trust area is instructive: for the most part, the “simple” and “complex” trust rules in subchapter J do not produce different tax outcomes for simple trusts. Rather, two sets of rules are provided “to prevent burdening … simple trusts with the complicated rules that are needed only for the problems of the complex trusts.”\(^ {26}\)

Finally, development of a simplified system for a subset of firms opens up the possibility of meaningful reform of the regular conduit system applicable to all

\(^{23}\)See I.R.C. § 751(b)(1).


\(^{25}\)See I.R.C. § 751(b)(1); Treas. Reg. § 1.751-1(b).

other firms. Because such reform may make subchapter K even more complicated than it is today, it is effectively blocked so long as smaller taxpayers with less sophisticated advisors are subject to those rules. The end result is an unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.

Accordingly, we recommend development of two different versions of conduit taxation. The starting point for each version would be the provisions of subchapter K and the goal of each version would be to produce as administrable a set of operating rules as possible. One version, however, would be developed for a subset of private firms whose organizational and operational structure is relatively simple and straightforward. Careful identification of the eligibility requirements for this version should allow for a much more workable set of conduit rules, perhaps with some concession to not always achieving the precisely correct tax outcome in all cases. The other version, to be applicable to all firms ineligible for, or electing out of, the first version, could then concentrate on “getting the rules right” to prevent inappropriate tax outcomes. The next part provides the principal details regarding how these two systems would be developed and coordinated.

IV. Implementing the “Two-Track” Approach.

This part briefly addresses the three principal implementation issues presented by our proposals. We consider the eligibility conditions for firms entitled to use the simplified version and the general terms of the simplified and regular conduit tax systems.

A. What firms would be eligible to use the simplified system? -- The purpose of developing a simplified version of conduit taxation is to provide a mechanism to relieve many private business firms of the enormous complexity of the subchapter K rules. As noted, the rules impose significant compliance burdens on taxpayers, with many observers suggesting that there is widespread disregard of one or more of the subchapter’s requirements. Although smaller economic firms may have the greatest difficulty dealing with the rules, compliance problems are certainly not limited to those firms.

Simplification of the rules begins with some understanding of why they have become so complicated. Over 40 years ago, the reporters and two consultants to the ALI project on partnership tax described the source of the difficulty in subchapter K in the following way:

Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the
group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner.  

The passage of time since publication of that statement has revealed that the authors were only partly correct. Certainly, one of the principal difficulties of partnership tax has been the distribution or allocation of the tax burden of the business firm among the owners of the business. But in contrast to the second sentence of the quoted statement, which lay the groundwork for the authors’ proposal of what is now section 704(a), it would appear that the Treasury Department is greatly concerned with the manner of allocation. For example, the regulations under section 704 evidence Treasury’s concern that the flexibility of the subchapter K rules will be used to shift tax items from one owner to another. This concern is not limited to the possibility that income will be shifted from high-taxed to low-taxed persons, while deductions flow from the low-taxed to the high-taxed. Also included are possible shifts of particular categories of income -- section 1231 gains and losses, foreign-source income and deductions, capital gains and losses, passive income and losses, and so forth. Moreover, the shift need not necessarily be within a particular time period. The shifting of income, deductions, losses, and other tax items recognized in different time periods may also be objectionable.

The theory of our recommendation is to identify the characteristics of firms for which the second sentence of the ALI reporters’ statement would also be true, that is, firms whose tax issues would be essentially between owner and owner rather than between the Treasury and the taxpayer. If the characteristics of such firms offer only limited potential for the type of tax advantages that the Treasury is worried about, then the firm can be provided with an operating rule structure consisting of a stripped-down version of subchapter K, one that eliminates many of the burdensome compliance requirements of those provisions. To be sure, the eligibility conditions cannot be so precise as to preclude every possible instance of the firm being used to achieve an advantageous tax result. Nevertheless, the objective of our recommendation is to balance a concern of protecting the fisc with a desire to provide an administrable set of tax operating rules for as many firms as possible.

Consistent with that goal, we recommend that there be two basic eligibility conditions for firms entitled to use the simplified version of conduit taxation. First, the firm must generally be owned only by individuals who are not nonresident aliens. Thus, public firms taxed under subchapter C, foreign persons, and tax-
exempt entities would all be excluded as potential owners of an eligible firm. Our examination of data published by the IRS suggests that many domestic, individual owners of current subchapter K or S firms are taxed in the 28 percent or higher marginal income tax bracket. Moreover, even where that is not the case, we believe there would be limited opportunity for such taxpayers to gain tax advantage from certain shifting strategies through ownership of a private firm. By contrast, many of the excluded owners are taxed at a low or zero (or negative) marginal income tax bracket and would afford ample opportunity for tax advantage if they were included as possible owners of eligible firms. Accordingly, their exclusion as owners should allow for simplification of the operating rule structure.

Although this ownership restriction is designed to insur that most owners have roughly the same tax profile and therefore cannot easily benefit from income and loss shifts between one another, it would not be effective at precluding strategic shifts of categories of income and loss and other tax items. For example, two high-bracket owners would not ordinarily benefit from shifting ordinary income from one to the other. But if one owner had unused capital losses and the other did not, the two owners might both benefit from a shift of capital gains to the owner with the capital losses. Thus, to preclude such possibilities, a second condition is necessary -- we would require all eligible firms to have only a single class of residual ownership interests. In effect, such a rule, similar to the “one class of stock” rule in subchapter S, would eliminate the possibility of item allocations. Every outstanding interest in the residual class would have to confer identical rights with respect to income, loss, distributions, and liquidation proceeds of the firm. Unlike subchapter S, we would permit multiple classes of a limited form of preferred ownership interests (analogous to debt) provided that a clear order of priority for the different preferred interests is established.

B. General description of the simplified version of conduit taxation. --
We recommend that the simplified operating rules consist of a liberalized version of subchapter S. We come to this proposal indirectly, for subchapter S was not our starting model for the rules of the simplified system. Indeed, subchapter S’s entity tax features, a natural outgrowth of the subchapter’s original application only to corporations and its close relationship with subchapter C, seemed to make it an unsound foundation on which to construct a simplified conduit version applicable to all forms of business organization.

Nevertheless, our analysis has led us to conclude that the operating rules of the simplified system should have a strong resemblance to subchapter S. In part, this result can be explained by the historical roots of that subchapter. Subchapter S was enacted in 1958 to reduce the impact of tax consequences on the choice of business form and to remove the double tax burden on, and permit the passthrough of losses by, small businesses. Although the creation of an administrable set of
provisions was not stated as a specific objective, it is evident that Congress included consideration of that goal in crafting the rules. Whether Congress has achieved that goal is a matter of some disagreement, but most observers surely would agree that subchapter S is far simpler than subchapter K. Thus, in trying to develop a simple conduit approach to a particular tax issue, it was natural to consider the rule in subchapter S. Indeed, the basic structure of subchapter S serves as a remarkably coherent version of a simple conduit system.

Subchapter S provided another important advantage. One worry in trying to fashion a “simpler” set of rules is the possibility that they will not be adequately protective of the fisc. Elimination of complicated subchapter K provisions intended to prevent inappropriate tax outcomes might result in such outcomes being resurrected within the simplified conduit system. Subchapter S, however, offers an instructive 40-year track record of taxpayers and transactions subject to those rules. Thus, if a transaction with an inappropriate result has not arisen under that subchapter, it may be indicative of the experience one could expect under a new system modeled after one or more of its rules.

A difficulty with relying too heavily on subchapter S, however, is its somewhat perverse relationship to subchapter K. Assuming that use of the simplified conduit version is a matter of explicit or transactional election by the taxpayer, then the substantive tax outcomes under that version must be coordinated with those under the regular conduit version, which we assumed would be a closer variant of subchapter K. Unless the results under the simplified version are roughly equivalent to (or indeed, more taxpayer-favorable than) the results under the regular system, use of the simplified version might well be discouraged. Yet current subchapters K and S do not have that relationship. Subchapter S is simpler than subchapter K but it also generally produces tax results less favorable to taxpayers. As a result, some commentators have predicted the demise of subchapter S and some have even urged its repeal.

For reasons previously described, we believe it is important to preserve a simplified version of conduit taxation for as many private business firms as possible. To accomplish that end, it is necessary to reconfigure somewhat the tax consequences under subchapters S and K. Far from being repealed, the former should generally be liberalized in the simplified system; in contrast, some of the vaunted flexibility of the latter should be curtailed in the regular version of conduit taxation. The challenge is achieving the right balance: liberalization of subchapter S should not result in any significant loss of simplicity, and modifying subchapter K should not cause it to produce incorrect results.

We propose that the simplified operating rules consist of subchapter S with the following principal modifications: (1) the firm would be allowed to have a
limited form of preferred ownership interests; (2) contribution transactions would generally be taxed in accordance with the partnership tax rules; (3) indebtedness of the firm would be passed through and taken into account in the outside basis of the firm’s owners; (4) the collapsible corporation rules would no longer be applicable, but certain provisions to prevent income character conversion following a contribution would be included; and (5) conversion of a firm from public to private status would generally be a taxable event. Most of these differences serve to liberalize the rules of subchapter S, and most make those rules more consistent with conduit tax principles.

C. General description of the regular version of conduit taxation. -- In general, private business firms ineligible for, or electing out of, the simplified operating rules would be taxed under the regular version of conduit taxation. We recommend that the regular conduit rules consist of subchapter K as modified by selected reforms. Unfortunately, in this brief paper, we cannot present fairly the nine specific reforms we include in our ALI Reporters’ Study. Instead, we describe in this section the basic rationale for what is perhaps our most controversial recommendation -- our proposal to treat a distribution transaction under the regular conduit rules as a taxable event to the firm and to the distributee in the same general manner as under current subchapter S.

In general, the rules relating to property contributions and distributions between an owner and a private business firm should achieve the following tax policy objectives:

- **Preservation and proper allocation of amount of gain and loss** -- The transaction should not change either the amount or the allocation of gain or loss in existence immediately prior to the transaction;

- **Preservation and proper allocation of character of income and loss** -- The transaction should not change either the amount or the allocation of the character of income in existence immediately prior to the transaction;

- **Minimization of basis shifts** -- Even assuming that the amount and character of income is properly preserved and allocated, the transaction should minimize basis shifts from one property to another; and

- **Nonrecognition** -- To the extent compatible with the other objectives, the transaction should result in the nonrecognition of any gains or losses realized.

The original, 1954 subchapter K rules concerning property contributions and distributions reflect a strong desire by Congress to fulfill the last objective
mentioned above -- nonrecognition. The 1954 Congress provided that contributions of property by a partner to a partnership should always be tax-free to both the partner and the partnership. In addition, it approved broad nonrecognition rules in the case of partnership distributions, in the process rejecting a House Ways and Means Committee recommendation that would have taxed more of those transactions.

Even in 1954, however, Congress recognized to some degree the paramount importance of the first two policy objectives: the need to preserve the amount and allocation of gain or loss prior to the transaction, and the amount and allocation of income character. This awareness is demonstrated by the adoption in 1954 of three deviations from a blanket nonrecognition rule on distributions. First, in deference to the first objective, Congress required a partner to recognize gain or loss on a cash distribution in circumstances where a nonrecognition result would not have been able to preserve the proper amount of gain or loss. Further, in deference to the second policy objective, Congress required a partner to recognize loss on certain liquidating distributions where only money, unrealized receivables, and inventory items were distributed, in order to prevent the shifting of basis to those ordinary income assets. Finally, Congress recharacterized certain distributions as taxable exchanges to both the partnership and the partner if, as a result of the distribution, there was a shift in the partners’ shares of unrealized receivables and substantially appreciated inventory items of the partnership.

Since 1954, Congress has adopted a series of amendments to the partnership contribution and distribution rules that provide additional evidence of the primacy of the first two tax policy objectives over a goal of nonrecognition. In general, Congress has approved provisions designed to maintain the proper allocation of gains and losses following a contribution, and to preserve the amount and allocation of income character following both contributions and distributions, often achieving those ends by further compromising the nonrecognition objective.

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28See I.R.C. § 721(a), substantively unchanged since 1954.

29See I.R.C. § 731(a) and (b), substantively unchanged since 1954.

30See I.R.C. § 731(a)(1) and (2)(A), unchanged since 1954.

31See I.R.C. § 731(a)(2), substantively unchanged since 1954.

32See I.R.C. § 751(b), substantively unchanged since 1954.

33See, e.g., I.R.C. §§ 704(c)(1)(A), 704(c)(1)(B), and 737.

34See, e.g., I.R.C. §§ 724, 732(c), 735(c)(2), 751(b)(3), 751(c), and 751(d).
In addition, in a few cases, Congress has reversed the nonrecognition result altogether where it considered that outcome to be inappropriate, even apart from concerns relating to the first two objectives.\(^{35}\) Taken together, these changes have greatly increased the compliance costs and administrative burdens of partnership contributions and distributions to taxpayers and the IRS.

Despite these changes and the amount of time that has transpired since the original set of rules were adopted, the first two policy objectives for contributions and distributions remain elusive. Simply put, the rules do not always preserve immediately after the transaction either the proper amount of gains and losses in existence just prior to the transaction or the proper allocation of such amounts among the owners of the firm. Further, the rules do not always continue the appropriate amount and allocation of the character of the pre-transaction income and loss.

Although Congress has not yet seen fit in the partnership area to address the third policy objective noted -- the minimization of basis shifts apart from concerns regarding the preservation and allocation of income character -- it has done so with respect to another nonrecognition transaction, like-kind exchanges.\(^{36}\) The basic concern is the shifting of basis between properties where one is more likely to be disposed of than the other. Unfortunately, current law provides ample opportunity in the partnership area to achieve this outcome. The amendment in the like-kind exchange area may evidence greater sensitivity on the part of Congress to this issue, and may foreshadow future amendments applicable to partnership transactions to forestall this practice.

All of these continuing problems, in combination with the burdensome nature of the existing rule structure, suggest that some significant changes in the taxation of contributions and distributions are in order. Accordingly, for the regular version of conduit taxation, we generally recommend adoption of the subchapter S rules for the tax treatment of distributions by firms. Thus, a firm would recognize gain on the distribution of property to an owner as if the firm sold the property to the owner for its fair market value. Loss would also be recognized by the firm if it completely liquidates. After the passthrough of any gain or loss recognized by the firm, the distributee would compare the amount distributed with the distributee’s outside basis. A distributee would recognize gain in a distribution that does not completely liquidate the distributee’s interest in the firm, and gain or

\(^{35}\)See, e.g., I.R.C. §§ 707(a)(2), 721(b), 351(e)(1), and 731(c). The common theme of these provisions is the judgment that the transaction is more like a sale than a bona fide contribution or distribution between an owner and a passthrough entity.

\(^{36}\)See I.R.C. § 1031(f).
loss in one that does. The distributee would obtain a fair market value basis in any property distributed.

Adoption of the corporate subchapter S rules might initially seem odd because of their anti-General Utilities origin and their purpose of preserving the corporate tax base. Obviously, as in the case of distributions by current S corporations with no prior history as a C corporation, such purpose has no applicability to distributions by firms taxed under the regular version of conduit taxation. Rather, the subchapter S rules are proposed because they constitute rules of recognition. We have concluded that it is simply not possible, or at least not possible without an inordinate cost in complexity, to provide widespread nonrecognition treatment of distributions while still achieving the other policy objectives for such transactions. As Congress first made clear in 1954 and has made even more clear since then, where these policy objectives are in conflict, the nonrecognition goal must yield. Indeed, in view of the changes enacted by Congress since 1954, many distributions are not nonrecognition events today. Thus, our recommendation is just one further step in this evolutionary process to treat a distribution as a recognition event. It is an important step, however, because it facilitates significant simplification of the law. It is not mere happenstance that subchapter S has managed to stay remarkably free of many of the complications now included in subchapter K. Our proposed change facilitates repeal of a host of provisions, including sections 751(b), 704(c)(1)(B), 731, 732, 735, and 737.

Another possible criticism of our proposal stems from the view that the S corporation treatment of a distribution is consistent with an entity theory of the firm whereas the current partnership rules favor the aggregate or conduit theory. Therefore, according to this argument, our recommendation runs counter to an objective of taxing private firms in accordance with conduit tax principles.

In fact, however, neither the S corporation nor the partnership rules are completely consistent with either an aggregate or an entity theory of the firm. An entity theory would suggest that property transfers between the owners and the firm are generally taxable ones. There might be some relaxation of that result in cases where the firm is an alter ego of the owner, and the transfer therefore effects a mere change in form in the owner’s investment. But certainly, an “alter ego” exception would not support the general rules in the partnership area, which permit virtually any transfer of property between a partnership and partner potentially to be tax-free.

An aggregate theory of the firm would suggest that transfers between an owner and the firm constitute in substance transfers among the owners. Thus, if a contributor of property is the sole owner, or nearly so, of the firm, one might excuse the existence of a taxable event because the contributor is merely transferring the
property to himself or herself. But, under an aggregate theory, one would certainly not extend tax-free treatment to the lengths provided by the partnership rules. Under the aggregate theory, a group of investors who join together to pool their respective capital have made a substantial change in their property rights as a result of the pooling and, under normal income tax principles, they ought to be taxed.

The cost in complexity of nonrecognition treatment of a distribution might be worth bearing if there were a compelling policy justification for that outcome. But neither valuation and liquidity problems, nor concerns about lock-in, provides any such justification. The starting point, under either an aggregate or an entity view of the firm, is that a distribution constitutes a taxable event. The current nonrecognition rule that trumps that outcome is one “of stunning scope and flexibility,” and permits deferral (and, potentially, income character conversions, misallocations, and basis shifts) in circumstances that go well beyond the normal instances where nonrecognition treatment of sales or exchanges is permitted, such as like-kind exchanges and corporate reorganizations.

A final reason for this recommendation is that it conforms to the general tax treatment of distributions. An identical rule is proposed for the simplified version of conduit taxation, and essentially the same rule exists in subchapter C, applicable to public firms. The only exception is for distributions by sole proprietorships, which continue to be nontaxable events but which also present tax issues different from distributions by firms. Consideration should be given to possible nonrecognition exceptions to our recommendation if they can be implemented without a significant loss of simplicity.


38Cf., e.g., I.R.C. §§ 704(c)(1)(B) (exception for distributions of property back to contributing owner), 731(c)(3)(B) (gain recognition generally limited to disproportionate portion of property distributed). It may also be appropriate not to apply the recommendation to a technical termination of the firm under section 708(b)(1)(B), assuming that that rule is continued. Cf. Treas. Reg. §§ 1.704-4(a)(4)(ii), -4(c)(3) (inapplicability of section 704(c)(1)(B) to technical terminations), 1.737-2(a) (inapplicability of section 737 to technical terminations).

More generally, it may be possible to allow tax-free treatment of pro rata distributions of property that leave all owners with the same direct interest in property that they had indirectly through their ownership in the distributing firm. Each owner would hold the property with the same basis as the owner’s pro rata share of inside basis in the property just prior to the distribution. If this approach were followed, rules would be needed to deal with situations where the owner’s outside basis is less than the pro rata share of inside basis in the property. One possible solution would be to require the owner to recognize gain equal to any such amount.
V. Conclusion.

In this paper, we have argued that the income taxation of private business firms should be reformed and simplified. There is simply no policy justification for allowing such firms to continue to choose among subchapters C, K and S for their applicable income tax rules, and the existence of the choice unnecessarily complicates the law. We would instead generally treat all private firms as conduits for income tax purposes. Conduit taxation disregards the existence of the firm for tax purposes as much as possible. In addition, because conduit taxation can be extremely complicated, and because needed reforms may only make it more so, we propose that the recommendation be implemented through a “two-track” approach. A simplified set of conduit tax rules would be used by certain private firms unless they elect otherwise, and a regular set of conduit rules would be used by all others. In general, the simplified rules would be available only to firms that are owned exclusively by individuals and that have surrendered some flexibility in their economic arrangement. The simplified rules would resemble a liberalized version of current subchapter S, whereas the regular conduit rules would consist of the subchapter K rules as modified by selected, proposed reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform and simplification of the tax laws. While many details need to be carefully thought through, we believe that the recommendations outlined in this paper offer the potential for achieving that happy combination, and we urge policymakers to give them serious consideration.