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The Honorable Dave Camp,
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Re: Discussion Draft 3: Comments Regarding Pass-Through Entities

Dear Chairman Camp:

I write with some early thoughts on the discussion draft of options for reforming the tax treatment of small business, released by the Ways & Means Committee on March 12, 2013.

The process of real tax reform demands hard work and occasional missteps from which we learn and build. Option 2 is an example of both. The hard work required to meld the best ideas from Subchapter K and Subchapter S, and to add some new ones, has produced an amalgam that would be good for no one, especially the small businesses of America that it is intended to benefit.

What is not broken in Subchapter S. At last official count, there were over four million S corporations. On its face, this figure is astonishing. In almost all respects, an S corporation is inferior (in the eyes of a tax lawyer) to an LLC. No special allocations. Entity debt excluded from the shareholder's basis. Taxable (gasp) property distributions. And yet they keep coming, 100,000 or more new ones every year. How can this be?

It's because the small businessmen and businesswomen who set up S corporations don't care about special allocations. They intend to make money and grow, and the tax consequences of passed-through losses and liquidating distributions are far from mind. Botched-up self-employment taxation, and now apparently net investment income taxation, is appealing. But that is far from the main point. The most important thing these good people get from S corporations is what they don't get. No entity tax (usually). No big lawyer's bill for setting the thing up. No big accountant's bill every year for keeping the books and doing the tax return. And then there are the sections of the tax code that they have never heard of: 704(b), 704(c), 734(b), 737, 743(b), and 751, just to name an important few.

<u>What is not broken in Subchapter K</u>. Subchapter K is much more complicated than Subchapter S, but it has to be. The reason is that Subchapter K has a much more diverse clientele. Tax-indifferent parties are unwelcome in Subchapter S, but Subchapter K is an indiscriminant host. Foreign individuals and corporations, tax-exempt organizations, pension plans and tax-advantaged domestic corporations are all welcome. The diversity of the tax profiles of partnership investors make it the second-best vehicle in the world for buying and selling tax benefits. And that has prompted Congress and the Treasury Department to add a seemingly endless list of safeguards within and outside of Subchapter K to stop, or at least curtail, that activity. A list that, despite its length, always seems to be just a little too short.

The development of section 704(c) since 1954 is an example. Until 1984, application of that provision, which attempts to prevent the shifting of built-in gains and losses among partnership investors, was optional. The drafters of the 1954 Internal Revenue Code envisioned a world – their world? – of tax homogeneity, in which all or most partners paid tax at about the same rates.[1] In such a world, the shifting of the incidence of tax among partners was of concern to the partners themselves, who could if they wished regulate it by applying the rules of section 704(c), but not to the government. How times have changed. Since 1984, tax lawyers and accountants have been living in an ever-more-complex world of revaluations, section 704(c) layers, and mixing-bowl rules. However offensive these may be to one who craves simplicity in the tax law, they are absolutely necessary. In the absence of these rules, staggering amounts of taxable gain would simply disappear, courtesy of a pass-through tax regime serving heterogeneous actors.[2]

Why Option 2 can't work. The drafters of Option 2 were assigned an impossible task. Option 2 seeks to achieve a (1) simple, (2) pass-through, (3) universal system of taxation. The history Subchapter K teaches us that all three of these goals cannot be achieved at the same time. Here are some options:

Current Subchapter S is a simple, pass-through system that denies universal access. It limits the potential gains from tax arbitrage by limiting the players and thereby is able to achieve admirable simplicity.

Current Subchapter K is a universal, pass-through system that is far from simple.

Current Subchapter C is simple (relative to Subchapter K) and universal, but it is not a pass-through system. Adding a dividend exclusion would be an interesting idea and not particularly complex.[3]

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[1] Gergen, *The Story of Subchapter K: Mark H. Johnson's Quest*, in BUSINESS TAX STORIES 207, 220 (S. Bank & S. Stark ed. 2005).
[2] AMERICAN LAW INSTITUTE, TAXATION OF PRIVATE BUSINESS ENTERPRISES 5 (Reporters' Study 1999).
[3] U.S. DEPARTMENT OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 17-25 (1992).

Option 2 strikes about the same compromise among these policy objectives as Subchapter K does. It envisions a universal pass-through tax system that would be complex. Lest there be any doubt on this point, consider a few of the tax-compliance requirements that Option 2 would impose on small businesses everywhere:

- Because section 704(c) principles would continue to apply, every small business would have to maintain capital accounts, both on a book basis and on a tax basis. The alternative – the creation of an entirely new way to keep track of book-tax differences – would surely be worse. Presumably, small businesses would have revaluations and reverse section 704(c) layers and all the rest.
- Small businesses interested in special allocations would have to comply with a brand new "consistent with economic interest" standard. This either is or is not the same standard that has been painstakingly worked out over the past 40 years, and would require either the maintenance of capital accounts or the maintenance of something else.
- Section 734(b) adjustments, improved relative to those provided by current law, would be mandatory in the case of both current and liquidating distributions.
- Section 743(b) adjustments would be mandatory.
- Section 751(b) would apply to any distribution to which it would apply under current law. Which is to say, virtually all distributions.

It is not a mistake that Option 2 includes these requirements. The universal access of the proposed tax system demands them. If one were to suggest to the talented drafters of Option 2 that these requirements be deleted in the name of simplicity, their answer surely would be no. It should be.

<u>Whither from here</u>? There is nothing wrong with two tax systems for small business if they accomplish different things. Keep, and keep perfecting, Subchapter K. Keep, and keep perfecting, Subchapter S. The ideas in Option 1 are good and will benefit from further consideration. There are four surprising omissions from the list that deserve attention.

First, and most important, the tax treatment of property distributions in Subchapter K is seriously out of step with modern life. The current rules were drafted a half century ago, and were uneasily justified at that time by the observations that (1) partnerships don't often distribute property and (2) anything else would be too hard.[4] In its deliberations, the Committee will likely learn that neither justification is true anymore. Option 2 would essentially apply the distribution rules of Subchapter S to all small business entities. This is one possibility for reform – but not the only one and maybe not the best. There is work to do here.

Second, section 736 should be repealed. It was gutted in 1993 – for good reason – and what's left is handled more correctly by other provisions.[5]

Third, section 704(c)(1)(C) should be repealed, because mandatory section 743(b) adjustments would render it superfluous.

Finally, the elective classification system ("check the box") should be extended to most privately owned corporations. The Treasury Department might have done this already, but presumably feels it lacks the authority to do so.

I hope I speak for many in expressing thanks for the opportunity to think and talk about these important issues well in advance of final Congressional

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[4] Jackson, Johnson, Surrey, Tenen, & Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1212-14 (1954).
[5] Postlewaite & Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with Section 736?* 100 NW. L. REV. 370 (2006).

action. I am glad that the Committee has engaged the tax community in this important task.

Yours sincerely,

Robert R. Wootton