Choice of Entity: Pass Through Entities

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I. INTRODUCTION

A. Aggregate-Entity Discontinuities in Subchapters K and S

Both Subchapter K and Subchapter S provide for entity-level determination of the entity's taxable gain or loss, I.R.C. §§ 703, 1363; but the results of such computations are passed through to the owners of the entity with each partner or S Corporation shareholder then individually reporting his or her "distributive" or "pro rata" share respectively, I.R.C. §§ 702, 704, 1366, and 1377(a). Concomitantly, the partner or S shareholder may then withdraw tax-free such share of taxable gain as well as his or her investment, I.R.C. §§ 731 and 1368, reduced, however, by any prior distributions and by his or her share of any prior loss, I.R.C. §§ 705(a)(2) and 1367(a)(2). Beyond this pass-through commonality, Subchapters K and S manifest discontinuities in most respects, generally reflecting an "aggregate" approach in the case of Subchapter K conflicting with an "entity" approach in the case of Subchapter S. See generally, Coven & Hess, The Subchapter S Revision Act: An Analysis and Appraisal, 50 Tenn. L. Rev. 569 (1983); Eustice, Subchapter S Corporations and Partnerships: A Search for the Pass-Through Paradigm (Some Preliminary Proposals), 39 Tax L. Rev. 345 (1984).

Even this pass-through core of the subchapters exhibits some aggregate-entity discontinuities between a partner's "distributive share" under Section 704 and an S shareholder's "pro rata share" under Section 1377(a). The various aggregate-entity discontinuities in Subchapters K and S generally (1) present traps for the unwary (albeit by-and-large mercifully less deadly since the Subchapter S Revision Act of 1982), (2) often still inflict unjust and not policy-driven burdens (administrative, substantive, and/or tax planning) generally on S corporations; and (3) contain tax planning advantages for the well-advised. Ironically, elimination of such features of Subchapter S was a fundamental goal of the 1982 reforms. See Joint Comm. Staff, Recommendations for Simplification of Tax Rules Relating to S Corporations 8 (JCS-24-80, April 30, 1980) ("Staff S Recommendations"). In short, aggregate-entity discontinuities between Subchapters K and S manifest a fundamental failure of tax policy. The pervasive differences between tax treatment of an S corporation and a partnership may be superficially obscured if only the pass-through features are focused on. Thus, in direct response to a Congressman's question in the 1987 House "Tax Treatment of Master Limited Partnership" Hearings a former Treasury official testified that there was no difference between a Master Limited Partnership and a Subchapter S corporation (except as to the latter's numerical ceiling on owners).

B. Aggregate-Entity Concepts in Subchapters K and S.

1. Subchapter K.

Commentators and cases agree that Subchapter K manifests a hybrid blend of "aggregate" and "entity" features. See Bennett v. Commissioner, 79 T.C. 470, 479 (1982), citing I McKee, Nelson & Whitmire, Federal Taxation of
Partnerships and Partners ¶ 1.102 (1977); Crane & Bromberg, Law of Partnership 16-29 (1968). A close study, however, of Subchapter K and its background teaches that an aggregate core predominates in Subchapter K. Such aggregate core seeks to treat the partner as if he or she were the individual entrepreneur in order to affect a more equitable result. The Code's treatment of "a partnership largely as an aggregate of individuals" was intended to offer flexibility "and to preserve some degree of individuality, for the members of small partnerships." Department of the Treasury, the President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals 118 (1978), reprinted in Message from the President of the United States Transmitting Proposals for Tax Reductions and Reform, H.R. 283, 95th Cong. 2d Sess. 277 (1978).

Subchapter K, however, employs the entity approach (1) to provide simplicity in determining and computing the entity's income and loss, I.R.C. § 703; (2) to provide (optional) simplicity, intended particularly for large partnerships, primarily as to contributions to the partnership, § 704(c), and transfers of a partnership interest, I.R.C. §§ 741 and 743(a); but see I.R.C. §§ 751 (applying a modified aggregate approach as to transfers of a partnership interest to the extent of a pro rata share of ordinary income assets of the partnerships); and (3) occasionally to prevent abuses, particularly as to partnership-partner transactions, I.R.C. § 707. The 1954 Code House Bill, would have imposed a more pervasive entity approach, particularly as to contributions of property with built-in gain or loss. The 1954 Code Senate Bill, as was its general approach, followed more closely the 1939 Code aggregate predominating aggregate-entity hybrid, but still adopted entity features as to contributions and transfers of interests, albeit providing aggregate elections which it anticipated small partnerships would use for the more equitable results. And the legislative history of the 1954 Code Conference Bill (which largely adopted the Senate Bill) stated that while the 1954 Code uses an "entity" approach in partner-partnership (non-partner capacity) transactions under Section 707, "[n]o inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the Internal Revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). But in the end Subchapter K failed to provide a single coordinated pattern affording predictability, as once had been called for. See Rabkin & Johnson, The Partnership Under the Federal Tax Laws, 55 Harv. L. Rev. 908, 949 (1942).

2. **Subchapter S**

The still-born 1954 Senate version of Subchapter S would have yielded no discontinuities with Subchapter K. A small (entrepreneurial) corporation and its ten or fewer individual shareholders, all of whom were actively engaged in the business, would have been entitled to have Subchapter K apply in determining their federal income taxation. S. Rep. No. 1622, 83d Cong., 2d Sess. 119, 453 (1954). This "check-the-box for Subchapter K to apply" model has been frequently advocated to Congress. See, e.g., Hearings (on Issues Relating to Passthrough Entities) on H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448 before the Subcommittee on Select Revenue Measures of the House, Committee on Ways and Means, 99th Cong., 2d Sess. 95 (1986) (Statement of John S. Pennell) ("Passthrough Entities Hearing"). Additionally,
under the 1954 Senate provisions two features were present which were to reappear sooner or later in the Subchapter S, namely only one class of stock was permitted "to avoid possible complications in the taxation of preferred stock dividends not earned in the year distributed." S. Rep. No. 1622, supra at 119. And presumably to require parity as to self-employed retirement plans (which were not tax favored or exempt until 1962 with full parity still 20 years later in 1982), S shareholder-employees could not under the Senate Bill participate in any tax-exempt plan of the S corporation. Id. at 119. In summary, the Senate Bill hoped to make it possible for small corporations which are essentially partnerships to enjoy the advantage of the corporate form of organization without being made subject to possible tax disadvantages of the corporation. It will thus eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances. S. Rep. No. 1622, supra at 119.

Such elimination of tax rules and choice of business entity unfortunately was not to be. Subchapter S (which had not been contained in the House Bill) was eliminated in Conference, where Subchapter C and K innovations tended to die in 1954. And the provision may have been provocative as well as innovative since its target group (at least in 1958) was taxpayers earning more than the lower Subchapter C inside corporate bracket (then 30%) but less than the upper Subchapter C inside bracket (then 52%). Compare S. Rep. No. 1983, 85th Cong. 2d Sess. (1958), reprinted in 1958-3 Cum. Bull. 1008 with Driscoll, Subchapter S - Its Role in the Tax Laws, 3 House Comm. on Ways & Means, 86th Cong., Ist Sess., Tax Revision Compendium 1726 (Comm. Prnt. 1959) ("Tax Revision Compendium").

Four years later in 1958 Congress enacted Subchapter S, but it shifted radically from an election into Subchapter K's aggregate-entity world to an election into a conduit-entity approach. The goal thus shifted, at least partially, from tax neutrality to a capital subsidy for "middle income" entrepreneurs. In the 1958 version of Subchapter S even integration followed an entity approach with actual, and year-end deemed, distributions losing in the S shareholder's hands their character in the S corporation's hands, except as to long-term capital gains. The 1982 Subchapter S revisions adopted an "aggregate" passthrough "virtually indistinguishable" from Subchapter K as to (1) timing and taxability of entity income and loss in the hands of owners, and (2) cash withdrawal of investment and share of retained earnings. But from its 1958 beginning and continuing after the 1982 revisions in most other significant aspects, Subchapter S follows an entity approach, usually in contrast with Subchapter K aggregate rules.

For example, corporate liabilities are not included in a shareholder's basis for his interest in the corporation, and special allocations are not a feature of S corporations. A transferee of an S corporation interest is not entitled to "step-up" the basis of his share of the entity's assets to reflect his purchase price. Joint Committee Staff, Tax Treatment of Master Limited Partnerships, 100th Cong., 1st Sess. 11 (1987) ("MLP Hearing Pamphlet").
The only articulated Congressional policy for the Subchapter S entity approach was simplification. See S. Rep. No. 1983, supra at 1958-3 Cum. Bull. 1009. In this context Subchapter S may be viewed at least in part as more of a resurrection of the House's 1954 aborted entity approach to Subchapter K than the Senate's 1954 aggregate-entity version of Subchapter S. This may be indicated by Chairman Wilbur Mills' preference for the entity approach as to partnerships for simplification. See Hearings on Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code before the House Comm. on Ways & means, 86th Cong., 1st Sess. 13 (1959) (remarks of Chairman Mills).

On the other hand, the entity-corporate form may have been thought necessary to encourage conversion of closely held C corporations to S corporation status without otherwise necessary toll charges on purging accumulated earnings and other C attributes. Indeed, most early S elections were made by existing C corporations. See Panel Discussion on Income Tax Revision before the House Comm. on Ways & means, 86th Cong., 1st Sess. 92 (1959) (colloquy by Chairman Mills). Such C to S conversions constituted a standard 1954 Code tax planning technique for close C corporations facing unreasonable compensation problems or accumulated earnings problems, as noted by the Senate Finance Committee and commentators. See Nicholson, Report on Subchapter S, Tax Revision Compendium, supra at 1741.

C. Non-Tax Discontinuities Between Partnerships and S Corporations

The major, and often decisive, non-tax difference between an S corporation and a general partnership is limitation of liability. The reality of such limitation is probably less than the conventional wisdom and is practically limited to tort liabilities. Even there the owner-operator may be liable for his/her own negligence as to the injury or in supervising the tortfeasor. The other traditional corporate advantages (continuity of life, free transferability of interests, and centralized management) simply are not present in most S corporations, particularly if most of the shareholders actively participate in the business.

D. Deep Structure Analysis: Conflicting Policies of Entrepreneurial-Like Treatment and "Simplification"

Under a deep structure policy analysis aggregate pass-through (a rationalized Subchapter K) should be limited to entities in which (most of the owners actively or materially participate in the business. Conversely separate entity treatment (perhaps with conduit passthrough as in current Subchapter S) should apply wherever the (most of) the owners do not materially participate. Measured against this model, current tax treatment of limited partnerships (particularly if large) and of owner-operator S corporations by and large falls short. The PAL rules, however, reflect this policy tolerably well.

Another policy may, however, support the separate entity treatment of an S corporation: simplicity. The historical record is mixed. And if such simplicity is sound and effective, a one time — all the way election for S corporations and partnerships should be the pattern.
II. SUBCHAPTERS K AND S'S AGGREGATE-ENTITY DISCONTINUITIES

A. Introduction

Probably the most widely recognized and criticized Subchapters K and S discontinuities lie in the area of entity liabilities for "outside" basis purpose and distributive vs. pro rata share of income and especially loss, particularly as to special allocations of "built-in" gain or loss and retroactive and special adjustments for owner-operator services. Differences as to purchase/sales of an interest and owner buy-outs can be as sharp if optional Subchapter K features are chosen abut largely disappear if they are not. Distributions cause disparities primarily in the case of S corporations that carry a C E&P past—a C "Doppelgaenger."

The true "sleeper" discontinuity may ultimately arise as to "partner capacity" and "non-partner capacity" transactions where the Deficit Reduction Act of 1984's amendments to Section 707(a) lay a foundation on the Subchapter K-side analysis as to whether the payment-distribution bears partner-entrepreneur risks. Such analysis could clarify a broad range of Subchapter K transactions. Subchapter S's complete lack of a similar framework proves that the apparent simplicity of per-unit of ownership allocations and single class of stock is not real.

B. Loss Pass Through

1. Basis Limitation: Share of Entity Liabilities

   a. Subchapter K

   Section 704(d) limits current deductibility of a partner's distributive share of partnership losses to the partner's basis in his/her partnership interest with indefinite carryover of suspended losses until the partner obtains basis. And Section 705(a)(1) adjusts the partner's basis in his/her partnership interest upwards for entity level income; while Section 705(a)(2) adjusts such basis downwards for distributions by the partnership and the partner's distributive share of losses of the partnership.

   By virtue of the interplay between the allocation of liability rules of Section 752 and the contribution to a partnership basis determination rules of Section 722, a partner's "share" of entity-level liabilities is treated under an "aggregate" approach as a "constructive" cash contribution by the partner to the partnership, hence giving rise to a basis increase. See Burke & Freil, Allocating Partnership Liabilities, 41 Tax L. Rev. 173, 174 n.4 (1986). Conversely, a decrease in a partner's share of partnership liabilities is treated as a constructive cash distribution. See generally, Lee, Constructive Cash Distributions, 22nd Wm. & Mary Tax Conference 129, 130.

   Treas. Reg. § 1.752-1(e), incorporating an aggregate approach, provides for "sharing" of partnership liabilities, distinguishing between (a) recourse and nonrecourse liabilities, and (b) general and limited partners. The regulation further states that recourse liabilities are determined in accordance with the partnership ratio for sharing losses, but a limited partner's share of such recourse liabilities is limited to unpaid capital contributions. In contrast, a liability as to which none of the partners has any personal liability, e.g., a non-recourse liability, is shared by all partners, including limited partners, in
the proportion in which they share profits under the partnership agreement. See generally, Coven, Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept, 74 Calif. L. Rev. 41 (1986). The seeming rationale is that (a) recourse liabilities upon default would trigger creditor claims against limited partners only to the extent of unpaid (or perhaps returned) capital contributions under local law; and (b) while any general partner would be severally liable for the entire claim, under subrogation he/she would have a claim for contribution from the other general partners in the proportion in which they shared losses. In contrast, nonrecourse liabilities would not be borne by any of the partners in the event of default, but rather would be paid off, if at all, from partnership profits and capital. Burke & Friel, Allocating Partnership Liabilities, 41 Tax L. Rev. 173, 178 (1986); Lee, supra at 135.

The existing Section 752 regulations (Congressionally mandated in 1984 for overhaul) are distressingly silent as to (a) determining profit and loss ratios for this purpose, particularly when partners share items differently as to special assets or income, residual value, cash flow, losses and profits, and (b) distinguishing between recourse and nonrecourse liabilities, other than in the most simple transaction. Particular uncertainty exists under them as to guarantees and indemnification agreements by general or limited partners, promises to make additional contributions by limited partners, and the splitting of a liability from a single lender in a recourse and nonrecourse fashion. More significantly, commentators attacked the existing regulation's distinction in general between recourse and nonrecourse liabilities as conflicting with Crane and economically as well as conceptually ill-founded. Coven, 74 Calif. L. Rev. supra at 43, 49-51; Burke & Friel, supra at 178-79.

Initially, the Service adopted a formalistic approach as to guarantees by partners, essentially turning on whether the guarantee was in the partner's individual capacity or partner capacity. Rev. Rul. 69-223, 1969-1 Cum. Bull. 184. This approach was useful to deny limited partners basis. However, in 1983 the Claims Court applied a similar formalistic approach to hold that a guarantee of an otherwise nonrecourse debt by a general partner was not a recourse liability, since any payment by the general would not be in its capacity as a partner. Raphan v. United States, 3 Cl. Ct. 457 (1984), aff'd in part, rev'd in part, 759 F.2d 879 (Fed. Cir. 1985) This analysis would surely allow all borrowings by a limited partnership to be structured as non-recourse at the partnership level, even though guaranteed by the general. An appalled Congress quickly (in 1984) directed Treasury to rewrite the Section 752 allocation of partnership liabilities regulations under "to take into account, where possible, the manner in which the partners share the economic risk of loss with respect to the borrowed amounts." H.R. Rep. No. 861, 98th Cong. 2d Sess. 868 (1984) (Conference Report). Congress anticipated that

the regulations specify that a partnership debt for which a partner is primarily or secondarily liable, whether in his capacity as a partner or otherwise, is not a nonrecourse debt, and thus generally does not provide limited partners with additional basis for their partnership interests. Similarly, when a limited partner guarantees what is otherwise a nonrecourse debt of the partnership, the regulations will not shift the basis attributable to that debt away from the limited partner as a result of the guarantee.
Congress apparently approved the distinction in the existing regulations between recourse and nonrecourse debt, intending that the revisions to the Section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt, as defined by such regulations), with respect to bona fide nonrecourse debt, the conferees do not expect that such regulations will make major changes to the manner in which the partners' shares are determined, but may attempt to provide more certainty than presently exist. Id. at 869.

Subsequently, the Tax Court adopted an economic analysis under which the determinative factor was whether the limited or general partner guaranteeing the partnership loan would be "ultimately liable" in the event funds from the partnership's operations or investments were not adequate to service the loan. Abramson v. Comm'r, 86 T.C. 360, 374 (1984); accord, Melvin v. Comm'r, 88 T.C. 63, 75 (1987); Gefen v. Comm'r, 87 T.C. 1471, 1501 (1986).

Had these decisions been handed down earlier, Congress need not have acted in 1984, calling for revision of the Section 752 regulations but approving the old distinction between recourse and non-recourse debt. Unfortunately, commentators have extensively and ably shown that such distinction in the present Section 752 regulations, apparently approved by Congress, is neither conceptually sound, based upon Crane, nor consistent with the actual debt default experience and economic practice, whether recourse or nonrecourse, particularly in tax shelters. Coven, 74 Calif. supra at 50-51. Commentators have suggested various alternatives: (1) total freedom of allocation between the partners, leaving policing of economic substance to Sections 704 and the at risk and other anti-tax shelter provisions, Burke & Friel, supra; (2) maintaining the distinction between nonrecourse and recourse debt, while amplifying the method of which profit and loss ratios are determined and giving basis to partners guaranteeing debt at least where nonrecourse, American Law Institute, Federal Income Tax Project Subchapter K 253-80 (1984) ("ALI-Draft"), a half-way measure likely to be followed in the Section 752 regulations; and, (3) basing the sharing of liabilities, whether recourse or nonrecourse, on the profit sharing ratio, Coven, 74 Calif. supra at 59, which is more sound conceptually. The first course ignores the serious conceptual and practical lacunae in the at-risk and the Section 704(b) regimes. Following the first course leads to the 1986 Code PAL as the only practical, or perhaps better only political, answer for tax shelter abuse. Reform of the underlying combination of tax preferences plus leverage, the abandoned approach of Treasury I, was politically impossible in 1986, as in 1976 for the LAL. Instead, in 1986 we got the PAL essentially for noncorporate users of preferences plus leverage (and closely held services corporations) and a tough minimum tax for corporations other than small and closely held corporations) that extensively used preferences and usually leverage as well.
b. **Subchapter S.**

Just as in the case of a partner, the owner's, i.e., S shareholder's, current deduction of his/her "proportionate share" of the S corporation's flow-through loss is limited to his/her basis in his/her investment, i.e., unrecovered basis in his/her S corporation stock and his/her loans to it. I.R.C. § 1366(d)(1). Similarly, like the Subchapter K rules, Subchapter S has provided since 1982 an indefinite carryover of suspended or disallowed losses and deductions. I.R.C. § 1366(d)(2). Unlike the aggregate approach partnership rule, however, such stock basis under the S corporation entity approach does not include his/her "share" of all of the entity's liabilities, even if endorsed by him/her as long as such liability constitutes "true debt." Coven & Hess, supra 50 Tenn. L. Rev. at 667-69; Coven, supra 42 Tax L. Rev. at 384-85. Instead, an S shareholder may currently deduct flow-through S corporation losses above to an amount equal to his/her basis in his/her stock only in an amount equal to his/her basis in any loans made by him/her to the S corporation. I.R.C. § 1366 (d). Conversely, basis in such debt is "restored" first and then basis in stock by his/her pro rata share of the S corporation's subsequent separately and nonseparately stated items of income. I.R.C. § 1367(b)(2)(B).

Although not without minor complexities, these S corporation stock and loan basis loss flow-through limitation rules are far simpler than the partnership rules concerning sharing of entity level debt. The drafters of the S corporation provisions employed in this context the entity, rather than aggregate, approach. Under the aggregate approach the shareholder would have been treated as owning a proportionate interest in the entity's assets, just as partners in partnerships. Most likely the S corporation entity liability rules were at least retained in 1982 in such an entity manner in order to retard the use of S corporation as a tax shelter vehicle. Of course, commentators quickly suggested planning alternatives, viz., direct shareholder-level borrowings which the shareholders then would loan to the S corporation. See Mullaney & Blau, An Analytic Comparison of Partnerships and S Corps as Vehicles for Leveraged Investments, 59 J. Tax. 142, 143 (1983); August & Sillow, S Corporation vs. Partnership for Real Estate Ventures, 1 J. Tax of Invest. 91, 119-22 (1984). Regardless of the practicalities, or indeed point, of that exercise, denial of use of S corporation debt as basis does not attack the underlying income distortion from leverage and preference just as the similar in effect at-risk rules fail. Rather, the S corporation rules (and at-risk rules) are directed more towards the recourse-nonrecourse dichotomy than towards the underlying mismatch. If a surrogate approach must be taken here due to politics, the 1986 Code PAL for tax losses approach is far better than the 1976 at risk approach.

Finally, the S corporation entity level debt rules frustrate accustomed business tax practices. According to conventional tax wisdom under the 1954 Code rules, the best financing for a close C corporation is entity-level debt, shareholder guaranteed if need be as is usually the case. Consequently, apparently following such old habits, start-up S corporations apparently too frequently are capitalized in the same manner with entity level debt guaranteed by the shareholders.

When the S corporation's losses exceeded the shareholder's basis in his/her stock and any loans made by him/her to the S corporation (hence were
financed through entity level debt), shareholder self-help resort to courts for a current deduction of the S corporation's losses, which would otherwise be suspended until basis was restored, has generated the complexity in this area. In Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), the Eleventh Circuit allowed the shareholder to recharacterize a transaction she had cast as a third party bank loan to a solely owned S corporation guaranteed by her as in substance constituting for tax purposes a loan to her by the bank followed by her contribution of the loan proceeds to her S corporation's equity. The Selfe test is whether the lender actually looked to the shareholder as the primary obligor, i.e., whether under traditional "debt-equity" analysis the taxpayer's guarantee amounted to either an equity investment in (or shareholder loan to) the S corporation. Also a release of the S corporation and substitution of the shareholder as primary obligor has proven a successful argument, at least with third party loans. Rev. Rul. 75-144 1975-1 Cum. Bull. 277; but cf. Underwood v. Comm'r, 535 F.2d 309 (5th Cir. 1976).

Just this sort of uncertainty and frustration of business practice too often renders use of an S corporation transactionally expensive. Clearly legislative rules would be preferable here to self-help judicial approaches with resultant uncertainty.

c. Conclusion

Entity-level debt should be treated consistently for purposes of the outside basis limitation on current deduction of pass-through loss from S corporations and partnerships. The recourse-nonrecourse approach taken under the partnership Section 752 regulations and likely to be continued under the 1984 mandated revisions, as well as the roughly analogous denial of entity level debt to shareholders (even if they endorse it), is not responsive to the underlying tax dynamics of preferences and leverage. Rather such approaches attack only a symptom of tax sheltering—non-recourse financing. Furthermore, such a distinction causes confusion between entity and aggregate approaches as to both partnerships and S corporations in a context in which the aggregate approach should apply to both as to entrepreneur owners. A better rule would be (a) a pure aggregate approach to entity-level debt, whether of an S corporation or a partnership as to such owners; and (b) an entity approach in both as to passive owners. Such debt should be shared by the active owners for basis—loss flow through purposes in the proportion that they share in the profits as to the element of potential partnership or S corporation income financed by the debt, or perhaps more precisely as they will be responsible for the future income used to amortize the non-deductible mortgage principal. This approach would be consistent with both the true debt analysis and a year-one year-two correlative adjustment, clearer reflection of income approach.


a. Subchapter K

In my opinion under a deep structure analysis an "aggregate" policy should underlie, or if necessary override, Section 704's allocation of income and loss rules. In order to treat each partner as near as possible as an individual entrepreneur the partnership should be looked through and the
"assignment of income" doctrine applied inside so that (a) income will be
allocated to the partner whose services or income earns the income, and (b)
losses will be allocated to the partner who bears them. The "rub" lies in
determining who bears losses particularly if attributable to non-recourse
partnership indebtedness. Treasury believes that under the 1954 and 1986
Codes, Subchapter K's system of partnership allocations constitutes its
"principal source of flexibility." Passthrough Entities Hearings, supra at 13

The ALI draft (largely the basis for Subchapter K) rested in large part
on the assumption that "the Treasury from the standpoint of tax policy is not
greatly concerned about... [the allocation]... of the burden of taxation
among the members of the group." Jackson, Johnson, Surrey & Warren, A
Proposed Revision of the Federal Income Tax Treatment of Partnerships and
Partners—American Law Institute Draft, 9 Tax L. Rev. 109, 110 (1954)
(footnotes omitted). (First two authors special consultants on partnerships;
last two, chief reporter and associate chief reporter for tax project); see
Hearings on General Revenue Revision before the House Comm. on Ways &
means, 83d Cong. 1st Sess. (Part 2) 1370 (1953) (statement of Johnson on
behalf of ABA). Therefore it stressed the partnership agreement as the
source for the determination of distributive share and relied upon a capital
account analysis. "Thus, under the Draft a partner is entitled to a
distributive share of loss only if he has actually suffered a monetary loss, i.e.,
only if he suffers a reduction in his capital account, or, under agreement, he
is liable to make up that loss to the partnership." Jackson, Johnson, Surrey &
Warren, supra at 115-16.

The ALI Draft defined "distributive share" solely by reference to the
"partnership agreement." Id. at 174 (the equivalent of § 704(a)). Congress
added the predecessor to Section 704(b), which initially provided that the
partnership "bottom line" Section 702(a)(9) distributive share allocation would
govern if (a) the partnership agreement were silent as to any item, or (b) the
principal purpose of any distributive share agreement of a particular item was
to avoid or evade federal income tax. The Senate Report explained that
where "a provision in a partnership agreement for a special allocation of
certain items has substantial economic effect and is not merely a device for
reducing the taxes of certain partners without actually affecting their shares
of partnership income, then such a provision will be recognized for tax
subjected, in revised Section 704(b), bottom-line allocations, as well as
special allocations, to the requirement of "substantial economic effect", thus
extending the Senate explanation to the whole. See Joint Committee Staff,

Thus, Section 704(a) now provides that generally the partnership
agreement's allocation formula determines a partner's distributive share of
the separate items of partnership income, gain, loss deduction and credit
which he/she takes into account separately under Section 702. The partners
are free to allocate these items in any way they choose, including "special
allocations" so long as the allocations made by the partnership agreement
have "substantial economic effect." I.R.C. § 704(b); see Passthrough Entities
Hearings, supra at 13-14 (statement of Mentz).
The development of "substantial economic effect" unfortunately more or less followed in the cases, Orrisch, Halladay, etc., and even more clearly by commentators, McKee, Partnership Allocations in Real Estate Ventures: Crane, Kresser and Orrisch, 30 Tax L. Rev. 1, 8-18 (1976); but see, Weidner, Partnership Allocations and Capital Accounts Analysis, 42 Ohio St. L.J. 467, 476 n.36, 483, 487-504 (1981), and even arguably the legislative history, see S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976), but see, Weidner, 42 Ohio State at 501, followed a "capital accounts" analysis, ultimately, essentially only requiring restoration of deficits in capital accounts. In the case of allocation of losses, other than attributable to the contributed property governed by Section 704(c), generally the "substantial economic effect" test of the revised Section 704(b) regulations requires "capital account maintenance" under a detailed regulatory web providing for (1) appropriate adjustments for contributions, distributions, and allocations; (2) liquidating distributions of positive balances; and (3) restoration of at least a part of any deficit in account balance upon liquidation of the partnership or of the partner's interest. Treas. Reg. § 1.704-1(b)(2)(ii)(b); see Lokken, Partnership Allocations, 41 Tax L. Rev. 545, 551 (1986); Passthrough Entities Hearings, supra at 33. Thus, tax accounting is to follow book or financial accounting, Marich & McKee, Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships, 41 Tax L. Rev. 627, 631 (1986) — but a book accounting system in which the principal features are dictated by the Section 704 regulations. Allocation of such deductions attributable to non-recourse debt must meet the additional test of consistency with other allocations with substantial economic effect. Treas. Reg. § 1.704-1(b)(4)(iv)(2). Unfortunately with these regulations, another tax area became "essentially inpenetrable to all but those with the time, talent, and determination to become thoroughly, prepared experts on the subject." Lokken, supra at 621. Moreover, they ignore time value of money considerations. See Passthrough Entities Hearings, supra at 48 (Kuller). Hence, they are invalid to that extent. See Sheppard, The Gauntlet: Joint Committee's Corporate Base Broadeners, 36 Tax Notes 9, 10 (July 6, 1987).

The revised Section 704(b) regulations also permit temporary allocations, so long as the "transitory" rules are not violated. An allocation automatically passes the transitory prohibition if it is expected to be for longer than five years. See Treas. Reg. § 1.704-1(b)(2)(iii)(e). Furthermore, in the case of a special allocation, if sale of the property to which the specially allocated item is attributable would result in an economic loss to the partner to whom the specially allocated loss had been allocated, the transitory rule is equally not violated. In the case of ACRS deductions, this test is applied by assuming that the fair market value of the property in question is equal to its adjusted basis after ACRS deductions. Id. Thus, a loss is guaranteed. Assistant Secretary for Tax Policy Roger Mentz argued in the 1986 Pass Through Entities Hearings that the combination of these rules produced an inappropriate result in the context of an incentive depreciation system, such as ACRS then and now, where tax depreciation deductions are likely to far exceed economic depreciation in the early years. Passthrough Entities Hearings, supra at 14. Mentz provided an illustration in which a general partnership, with recourse financing, provided a typical "flip-flop" of (1) net losses 99% to the capital partner and 1% to the service partner, and then (2) at the "turn around" (when the partnership first produced net income) a "charge back" of partnership income to the capital partner equal to the prior losses, and then (3) an allocation of income (and any further losses)
50%:50% to the service partner and the capital partner. Id. at 15. The partnership required restoration of capital account deficits. According to the Mentz the partnership allocation met the Treasury Regulations § 1.704-1(b)(2)(ii)(b) requirements.

(1) Capital accounts will be maintained properly, (2) upon liquidation of the partnership of any partner's interest, liquidating distributions will in all cases be made in accordance with capital accounts, and (3) partners are required to restore deficit capital accounts ..." Id. at 33 n.15.

In my view, this regulation is invalid to the extent that the allocations exceed the capital partner's actual capital contribution if the chargeback and deficit restoration obligation lies so far in the future that their present value impact is small. In such cases the chargeback and restoration requirement are virtually nonexistent economically. Cf. S. Prnt. No. 169, 98th Cong., 2d Sess. (vol. 1) 231 (1984). Where such features actually were non-existent, courts readily held that a purported allocation of loss lacked economic substance, Holladay v. Comm'r, Allison v. United States, 72 T.C. 571, 588 (1979); accord, 701 F.2d 933 (Fed. Cir. 1983). In practical effect in such circumstances the assignment of income doctrine was violated in that some partners are accelerating income to the other partners in future years and are themselves sheltering income in the present years. In short, by ignoring time value of money, the regulations equally ignore the assignment of income doctrine as applied within the partnership. And the case law as to allocations of partnership net income clearly now requires application of assignment of income doctrine within the partnership. See p. _____.

The revised Section 704(b) regulations overlooking of the assignment of income doctrine should come as no surprise. Their chief conceptual architect, after initially arguing that in effect that an aggregate approach underlay allowing special allocations to produce deficit capital account (so long as a deficition restoration obligation was present, McKee, supra 30 Tax L. Rev. at 27, reversed position as to aggregate-entity and argued that the assignment of income doctrine stopped at the partnership entity's door, McKee, Partnership Allocations: The Need for an Entity Approach, 66 Va. L. Rev. 1039, 1050 (1980). McKee reasoned that once the partnership earned the items taking account of the assignment of income doctrine, the allocation within the partnership among the partners was covered solely by Sections 704(a) and (b). "The doctrine should not also apply at the partner level because, as between the partnership, nothing is 'earned'; rather, what has been earned is simply to be allocated among the partners." Id.

McKee then went on to Treasury where reportedly he was the chief architect of the Section 704(b) regulations project and the chief artisan was Mark Kuller. McKee and Kuller now admit that the Section 704(b) regulations "may need further refinement to adequately deal with time value of money and assignment of income issues, but we feel the Treasury already has sufficient regulatory authority to handle these problems." Passsthrough Entities Hearings, supra at 53 (statement of McKee and Kuller). See also Marich & McKee, supra, 41 Tax L. Rev. at 638 n.34, 640. Indeed, the Preamble to the revised Section 704(b) regulations states that the drafters welcome comment on time value of money principles. Preamble, 50 Fed. Reg. 53422 (Dec. 31, 1985).
2. **Subchapter S.**

The S corporation provisions allocate the pass-thru tax entity's income or loss (in most instances) to shareholders in accordance with their "prorata share," I.R.C. § 1366(a)(1), which in turn is based solely upon their proportionate stock interest during the tax year. I.R.C. § 1377(a). See Passthrough Entities Hearing, supra at 36. Therefore, the S corporation regime contains no provision for special allocations or more significantly for allocations with respect to contributed property. See Passthrough Entities Hearings, supra at 36.

To some extent the practical effect of special allocations may be achieved in an S corporation context by creative use of debt instruments according to some commentators. Coven & Hess, supra, 50 Tenn. L. Rev. at 569. (However, debt-equity may be a problem here. But the result would be "preferred stock," which is close enough to the estate planning goal). But especially as to allocations with respect to contributed property, the S corporation rules are inflexible, probably deliberately so, ostensibly for simplicity but possibly in order to retard their tax shelter use. Thus an S corporation unfortunately often is less able to meet legitimate nontax special interests of owners contributing business assets with significant built-in tax attributes.

3. **Conclusion.**

Assistant Secretary Roger Mentz suggested in the 1986 Passthrough Entity Hearings that an answer to exploitation of Subchapter K through tax-motivated partnership allocations, particularly flip-flops raise the question of revisions to Subchapter K to substantially restrict its flexibility.

One approach deserving study would be a partnership allocation system similar to that employed in subchapter S. Under this more rigid system, each unit of ownership interest in the partnership would be required to share equally in each item of partnership income, gain, loss, deduction, and credit and in each distribution made by the partnership. If the partnership did not meet this requirement, it would be taxed as a corporation under subchapter C, just as an S corporation that is found to have two classes of stock. Under such a regime, any shift in a partner's percentage interest in partnership items would, as with a transfer of shares in an S corporation, be characterized and taxed appropriately (or, for example, a purchase of an additional interest for capital, a receipt of an additional interest for services, or a gift). In developing such an approach, it could be desirable to analyze the possibility of a single system of pass-through taxation for all non-publicity traded business entities, which could replace subchapters K and S of current law.

Obviously, this possible approach to revising subchapter K, as well as any other possible revision of this magnitude, would require extensive consideration before enactment.
We recognize, moreover, that significant restrictions on the flexibility of subchapter K could adversely affect economic arrangements that appear to be taxed appropriately under current law. In this regard, it could well be appropriate to retain more flexible treatment for certain identified activities or industries. For example, service organizations might be permitted to shift allocations of bottom line income or loss without regard to units of ownership where such shifts respond to the shift from year to year in the relative values of services provided by the various partners. Passthrough Entities Hearings, supra at 36.

Such yearning for entity simplicity as to passthrough entities was a recurring theme throughout the 1954 Code. However, the blocking of legitimate business arrangements by a strict entity approach, particularly as to allocations, goes too far.

More equity would be obtained by revising the Section 704(b) regulations to reflect time value of money principles and hence assignment of income. Under such an arrangement a flip-flop would not be permitted to the extent that deductions created a negative capital account.

C. Income Passthrough.

1. Special Allocations of Income.

a. Subchapter K.

As discussed above in the context of allocation of partnership losses, Subchapter K's starting point in "allocations" or determining a partner's distributive share of items of income is the partnership agreement, which governs unless the allocation is without substantial economic effect. In the case of income allocations the "varying interest" cases clearly expose that the underlying principle of assignment of income, i.e., income must be allocated to the partner whose services or capital generated the income, governs. See p. ___.

Thus, in this context special allocations of geographic source income or even product line or other natural division corresponding with a partner's special services or capital investment should be permitted. And after 1984 the Code requires mandatory allocations to the contributor partner of built-in gain or loss property. I.R.C. § 704(c). The goal should be treatment of the partner as near as possible to an individual entrepreneur who employed his or her services or capital in a venture.

Special allocations of income to effect a charge back or loan amortization where the partner remains responsible for the loan or in effect responsible for the encumbered property should also be permitted.

i. Section 704(c) Allocations as to Contributed Property.

It was here that the House 1954 Code Bill required a mandatory entity approach with built-in gain and loss being allocated to the partners in accordance with their general distributive share allocation formula. The
Senate instead provided optional allocation of the built-in gain or loss to the contributing partner. Thirty years later in 1984 Congress concluded that abuses abounded with contributed property and mandated allocation of built-in gain and loss to the contributing partner under revised Section 704(c), at the same time providing character will be "carried over" for 5 years from partner to partnership for the first time in the Code in new Section 724. In essence, this provision mandates an aggregate approach as to the contributing partner. Revised Section 704(c)'s mandatory allocations as to contributed property with a differing basis from market are designed to eliminate book-tax disparity arising from mandatory accounting for the contributed property at market and, hence, potential assignment or other distortion of income where a partner contributed such "built-in" gain or loss property to a partnership. The mechanics of Section 704(c) may produce special allocations of gain and of loss, e.g., ACRS.

b. **Subchapter S.**

The Subchapter S regime follows a rigid per unit of ownership allocation formula as to allocations of income just as to allocations of loss. In this aspect a conduit-entity approach applies.

In practice, it appears that the effect, however, of special allocations, particularly as to services is readily achieved through compensation paid to shareholder-employees. Policy arguments supporting importation of Section 707(a)(2) principles into Subchapter S are discussed below at p. 29.

Similarly as to capital investment special allocations, arguably shareholder loans to the corporation can be used to effect the same results. Both techniques, however, raise the stakes of tax complexity. Both carry with them substantial Subchapter C history of reasonable compensation and unreasonable law and lore as well as debt equity law and lore. Unfortunately those issues are not as directly responsive to surely the underlying question here. Did the capital or services of the S shareholder earn the income? Also S corporations in which owners materially participate should be required to allocate income (and loss) in accordance with assignment of income and time value principles.

2. **Varying Interest Rules and Retroactive Allocations.**

a. **Subchapter K.**

i. **Varying interest rule.**

The ownership interest in a partnership can be changed on account of (a) admission of a new partner, (b) a change in the partnership's profit and loss ratio (often accompanied in a services partnership by corresponding capital interest increases—and hence capital contribution increases—and capital interest decreases—and hence distributions from capital—), or (c) sale or exchange by a partner of his/her partnership capital and profit/loss interest in the partnership to, or with, another. At least in a partnership in which capital is a material income producing factor, an assignment of a partner's capital interest and attendant profit share is effective under Evans v. Comm'r, 54 T.C. 40 (1970), aff'd, 447 F.2d 547 (7th Cir. 1971), to make the assignee a partner for tax purposes, even though the assignee may not be a
partner under state law (i.e., not able to have a voice in partnership affairs or to inspect its books, but usually entitled under local law to his/her assignor's share of any actual distributions by the partnership).

(A) Constructive Cash Distributions From Shifting Interests and Section 751(b)

Admission of a new partner to an existing partnership and shifting of interest between existing partners pose essentially the same problems. The decrease in the profit/loss ratio of the existing partners in both instances usually results in a decrease of the existing partner's share of liabilities. See Lee, supra 22d Wm. & Mary Tax Conf. at 134-36. It is probably rare that the resulting "constructive cash distribution" would exceed an existing partner's outside basis, but if it did such excess would be treated as a constructive sale or exchange under Section 751, except to the extent that Section 751(b) applies. But unless precautionary steps are taken, as discussed below, generally Section 751(b) will apply to restructure the constructive cash distribution as a constructive pro rata distribution of unrealized receivables of the partnership to the partner to the extent that the existing partner "gives up" a share of such receivables. Such constructive distribution of such constructive share of unrealized receivables is then deemed under Section 751(b) to be sold back to the partnership for its fair market value but with a zero basis, resulting in ordinary income to the new partner or partner with the increased profit/loss ratio. The partnership then has a stepped up basis in the unrealized receivable.

While the potential Section 751(b) problem in admission of a new partner or change in partnership interest was only recently recognized by the Service in 1984 (Rev. Rul. 84-102 1984-2 C.B. 119), commentators had noted the problem as early as 1970. They suggested to avoid the problem one precautionary step is for the old partners in the existing partnership before the admission or shift to expressly retain responsibility in the prior profit/loss ratio for the satisfaction of some or all of the partnership obligations which arose prior to the new partner's admission. See Emmons & Fine, Coping with IRS' Ruling which applies Sec. 751 on the Admission of New Partners, 62 J. Tax. 161 (1985). Reliance, however, on avoiding the constructive cash distributions through this manner would appear risky, if no more than in light of the mandated revisions to the Section 752 regulations. Over a decade ago it was suggested that the problem could be avoided by a special allocation charge-back of the pre-shift Section 751 receivables (especially potential partnership statutory recapture) to the existing partners in the prior profit/loss ratio so that the new partner or increase partner would not in the future have a distributive share in those old receivables when they were collected. See Lee, supra, 22d Wm. & Mary Tax Conf. at 137. This apparently is the route Treasury prefers as well. For the Section 704(b) regulations permit a restatement of the partnership's capital accounts upon an admission of a new partner (or presumably a shift of interest between the partners) accompanied by allocations under Section 704(c) "principles". Treas. Reg. § 1.704-1(b)(2)(iv)(F). Moreover, they hint not so gently that in many instances such a reallocation is mandatory lest other rules such as assignment of income embodied in various partnership Code provisions or Section 751(b) apply. Id. § 1.704-1(b)(2)(iv)(F)(5)(iii). This problem appears potentially applicable to most professional partnerships composed of attorneys or accountants. Additionally, a real estate partnership with assets
carrying potential depreciation recapture (Section 1245 or Section 1250) faces this problem since such potential recapture constitutes by statutory definition a Section 751(c) asset.

(B) **Varying Interest Restriction**

An additional question may be raised where a new partner enters the partnership other than on the first day of the partnership year or a shift in profit/loss ratio between the partners occurs other than on the first day of the tax year. At one time I thought that Sections 702 and 761 permitted retroactive amendments, in light of the early 1939 Code case law that overrode the assignment of income doctrine and permitted partners admitted late in the year to share in partnership profit and loss for the entire year, implicitly under an entity approach. Lee & Parker, *Retroactive Allocations to New Partners: An Analysis of the Area After Rodman*, 40 J. Tax. 166 (1974). The Tax Court in *Rodman* apparently thought so too, but was reversed by the Second Circuit on assignment of income grounds. Congress, effectively affirmed *Rodman* in 1976, by revising Section 704(b) and enacting the predecessor to Section 706(d)(1), which now provides that when partners' interests change or vary during the tax year, each partner's distributive share under Section 704 of various items of partnership income, gain, loss, deduction and credit is determined by taking into account his/her varying interest in the partnership during the taxable year. From 1976 to 1984 the varying interest rule permitted alternatively (a) an "interim closing" of the partnership books or (b) a pro ration of partnership income, gain, loss, deduction and credit for the entire taxable year. S. Prnt. No. 169, supra at 217. These two methods, however, left a "loophole" for cash basis partnerships, painted out by commentators. By deferring payment until after entry of the new partner or until after the partners' profit/loss ratios have been changed, a cash basis partnership could allocate a portion of an expenditure economically accrued prior to the entry or profit/loss shift but not paid until thereafter. S. Prnt. No. 169, supra at 218-19.

Congress closed this loophole in 1984 in enacting Section 706(d)(2) which pro rates "cash basis items" to each day in the period to which they are attributable and limits each partner's share, in a partnership year in which there is a "change" in any partner's interest, in proportion to his varying interest in the partnership on those days determined in a manner consistent with Section 706. The legislative history explains that this determination will require allocation of such items in the manner in which the partners would have borne the corresponding economic cost, even though the cost is actually borne by another partner (typically, a later-admitted partner) in connection with a change in the partner's interest. S. Print No. 169, supra at 219. "Cash basis items" include (1) interest, (2) taxes, (3) rents, (4) payments for services and any other item identified by the regulations as leading to significant mistatements of income. I.R.C. § 706(d)(2)(B). Again an aggregate approach prevails.

ii. **Retroactive Allocations Revisited**

Congress carefully explained citing *Lipke v. Comm'r*, 81 T.C. 689 (1983), that it wished to make clear that the varying interests rule is not intended to override the longstanding rule of section 761(c) with respect to interest shifts among partners who are members of the partnership for the
entire taxable year, provided such shifts are not, in substance, attributable to
the influx of new capital from such partners. See S. Print No. 169, supra at
219.

Congress could hardly have picked a worse example. Surely what it
properly wanted to carve out from Section 706's "varying interest" rule, was
the retroactive "grace" of Section 761 granting
current partners the right to adjust their respective allocations to
accurately [reflect] the fruitfulness, or lack thereof, of each partner's
contribution of capital or services to the partnership. In that case, the
current partners have sustained profit or loss during the taxable year
and all that remains to determine is the amount that each will bear.
Section 761 permits a change in this determination from that provided
in the partnership agreement. However, the allocations may not be
used as a vehicle to escape tax liability. ... Therefore, [Section] 761
has no relevance to an allocation of profit or loss to an individual who
was not even a member of the partnership when that loss or profit was
sustained. Snell v. United States, 680 F.2d 545, 548-49 (8th Cir. 1982)
(dictum).

Snell rejected a retroactive allocation to a new partner bottomed on
Section 761, on the grounds that the assignment of income doctrine barred
allocation of pre-entry profits or losses to a new partner. 680 F.2d at 598.
The above quoted illustration obviously did not violate the assignment of
income doctrine. First, the assignment of income doctrine now clearly
applies to the allocation of partnership income, embodying the principle of
attribution of the "fruits" to the capital or services (qua-partner) that earned
it. Compare Williams v. United States, 680 F.2d 382, 384-85 (5th Cir. 1982)
with Snell v. United States, supra; accord, Hawkins v. Commissioner, 713 F.2d
347, 351 n.6 (8th Cir. 1983); see also Richardson v. Commissioner, 693 F.2d
1189, 1195 (5th Cir. 1982). Cf. Rodman v. Commissioner, 542 F.2d 845, 857
(2d Cir. 1976).

A district court delving into "retroactive allocations," answered the
taxpayer's argument that the Comm'r v. Culbertson, 337 U.S. 733 (1949),
"intention to form a partnership" standard gave partner-status, regardless of
contribution of capital services, with (1) the observation that since all the
family partnership cases involved purported contributions," [t]he issue was
whether the amount, quality or origin of the capital or services was sufficient
to indicate an intent to establish a partnership." Atlas v. United States, 555
F. Supp. 110, 113 (W.D. Mo. 1982). (2) "[T]he Culbertson case clearly
establishes that there first must be some contribution of capital or services
before a person can be taxed as a partner. Then if his intentions are in doubt,
the case merits a further look." Id. (3) "Despite the passage of 33 years,
Culbertson is still good law." Id. In short, Culbertson as ready by Atlas and
Snell show that Section 761(c) is only meant to give partners flexibility to
retroactively allocate income (or loss) by amendment to reflect the
"contribution" to the partnership's business of each partner's contribution
"capital" (property?) or services for that year—an "aggregate" pooling of
resources approach.

Lipke, however, gives no intimations of an "aggregate" approach.
Instead, it proceeds mechanically, step-by-step (Sections 702(a), 704(a), and
761) to allow a retroactive allocation of 2% of profits or losses to "existing" general partners (prior to the retroactive allocation, the "generals" had only a "residual" profits interest, 81 T.C. at 698) because

"this reallocation of losses to the general partners was not directly accompanied by a reduction in any other partner's capital interest within the meaning of section 706(c)(2)(3). It constituted nothing more than a readjustment of partnership items among existing partners which, by itself, is permissible." 81 T.C. at 696.

There is no discussion in the Lipke opinion of application of the assignment of income doctrine to the retroactive 2% allocation to the general partners, nor of what particular contribution by them "earned" this "loss." Just as in its memo opinion in Rodman, the Tax Court following the literal words of the Code overlooked in Lipke the underlying policy—clear reflection of income of aggregate components of the pass-thru entity taking account of each's contribution. This is an easy mistake to make. See Lee & Parker, supra (citing 1939 Code family partnership cases refusing to apply assignment of income to retroactive allocations). Cf., Joint Committee Staff, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. (1976); see Moore v. Comm'r, 70 T.C. 1024 at 1228-29 n.3 (1977); accord, Williams v. United States, supra at 385-86 n.9.

b. Subchapter S.

In the Subchapter S arena there is no direct ability to merely shift a profits interest. Rather, there must be a change in stock ownership since the proportionate share of profits and losses is based upon stock ownership. See Passthrough Entities Hearings, supra at 36 (Mentz). This entity approach is consistently followed as to the pass-thru principle since the Section 1377(a) definition of "pro rata share" in effect provides for a proportionate approach throughout the year based upon averaged daily ownership. There is, however, a limited ability for a terminating shareholder to elect together with all other Subchapter S shareholders to treat the taxable year of the S Corporation as if it terminated upon the shareholder's termination of his/her interest. I.R.C. § 1377(a)(2). Subchapter S contains no provision similar to the partnership economic accrual of cash basis items rule.

Conceivably the equivalent of "retroactive services-produced allocation" can be accomplished by year-end bonuses to shareholder-employees. See p. 29 below. "Reasonable" compensation will raise its head again, however. Incidentally, under Section 162(a) year-end bonus are usually inadvisable.

Even the "AAA" rule in the case of S Corporations with C E&P follows an entity approach. See Coven, supra 42 Tax L. Rev. at 398. Thus a new S Corporation shareholder can avoid the dividend taint of the retained C E&P up to AAA even if accumulated prior to his/her acquisition of a stock interest. Of course, C E&P was accumulated previously as well.
3. Conclusion

The largely aggregate-based Section 704 rules, particularly as to mandatory special allocations of contributed built-in gain property and geographic-source special allocations appear more sound than a strict per unit of ownership allocation. Moreover, the ability to retroactively allocate according to relative contribution of services meets the needs of entrepreneurs. The S corporation per unit of ownership rules are overly rigid. While "compensation" to S shareholder employees supplies flexibility, this is largely so because S shareholder - S corporation transactions are not sufficiently delineated and regulated.

D. Non-Partner and Non-S Shareholder Capacity Transactions

1. Services

a. Subchapter K

i. Introduction

Non-partner capacity transactions constituted a major aggregate-entity conflict trouble spot throughout the 1954 Code era, continuing under the 1986 Code. The problem arose first under the 1939 Code in the context of salaries or guaranteed payments made to partners, with conflicting judicial adoptions of a aggregate and entity approaches. See Jackson, Johnson, Surrey & Warren, supra 9 Tax L. Rev. at 137; see also, Rabkin & Johnson, supra 55 Harv. L. Rev. at 921. Under the aggregate approach, salary payments, etc., were treated merely as a readjustment of the partners' distributive shares; however, this could require fragmentation of a transaction into two parts, "one of which should be recognized to the partners other than the one involved in the transaction, and another which should be handled as a contribution by the partner to the partnership or a current distribution from the partnership to the partner." Jackson, Johnson, Surrey & Warren, supra 9 Tax L. Rev. at 137. The entity approach treated the partner as an outsider dealing with the partnership, which was thought much simpler in operation. Id. Consequently, both the 1954 ALI Draft, Id. at 138-39, and the House bill, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 67 (1954), adopted the entity approach treating the partner as an "outsider" as to transactions between him/her and his/her partnership "other than in his capacity as a partner," Id. at A223; with certain safeguards (e.g., non-recognition and carryover basis as to "sales" to the partnership where it was "controlled" by the partner). Following this thought, the House bill adopted an entity approach as to the payment of a "fixed or guaranteed amount for services" treating the payment "as salary income to the recipient and . . . as a business deduction to the partnership," Id. at 68. The Senate essentially followed the House approach here, except as to contribution/sales where instead losses were disallowed by Section 707(b) as to sales of loss property by principal partners. S. Rep. No. 1622, supra at 94. Furthermore, it provided special timing rules as to "guaranteed payments" under Section 707(c), making "it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid and that this treatment is only provided for purposes of the reporting of the income by the partner and the deducting of the payments by the partnership." Id.
ii. Tri-partite Structure

Section 707 thus contemplates three categories of partner-partnership transactions:

a. Non-partner capacity payments, I.R.C. §§ 707(a)(1) and (a)(2);

b. Guaranteed payments, I.R.C. § 707(c); and

c. All other "payments" to a partner acting in his/her capacity as a partner, I.R.C. §§ 702, 704, and 731.

Non-partner capacity payments are treated as made to an "outsider"; hence, inclusion by the partner and deduction/capitalization, etc., by the partnership turn on general tax principles, e.g., cash or accrual methods, etc.

Guaranteed payments, reflecting the focus of the ALI and Senate Finance Committee on timing, Jackson, Johnson, Surrey & Warren, supra at 138; S. Rep. No. 1622, supra at 94, are taxed to the partner in the year the payment accrues.

All other payments (and allocations), i.e., partner capacity transactions, are governed by the general Subchapter K rules as to allocations, contributions and distributions. S. Rep. No. 1622, supra at 386.

iii. Non-Partner Capacity Transactions

Prior to the 1984 amendments to Section 707(a), the focus was on whether the rendition of services (or transfers of property or capital) was in a partner capacity. The Tax Court in Pratt v. Comm'r, 64 T.C. 203 (1975), aff'd, 550 F.2d 1023 (6th Cir. 1977), held that general partners receiving fees equal to five percent of partnership gross receipts for performing ongoing managerial services for the partnership were receiving neither Section 707(a) payments (because the management fees were received for services performed within the normal scope of the partners' duties and pursuant to the partnership agreement) nor (b) Section 707(c) payments to a partner (since computed as percentage of gross income and hence measured by partnership "income" and Section 707(c) payments are determined without regard to partnership income). Since the payments came under neither Sections 707(a) nor 707(c), the Tax Court held that Sections 704 and 702(b) applied to the allocation and Section 731 applied to the accompanying distribution. The Fifth Circuit affirmed the Tax Court as to its treatment of the management fees, i.e., treatment as an allocation and distribution, but solely on the "partner capacity" ground as to the Section 707(a) issue because the Section 707(c) holding was not appealed. The Fifth Circuit in Pratt focused on the "scope of the partnership".

It is perfectly clear that the contract creating the partnership, which provided for the percentage payments to the general partners for their management efforts was made with them qua partners. Furthermore, it is equally clear that the duties to be performed were activities for which the partnership was created in the first place, i.e., the management of the shopping centers. Bearing in mind, that the general statutory policy for treating partnerships for tax purposes contemplated that the income of a partnership
would flow through to the individual partners, it is not difficult to envision the purpose of Congress when it created an exception to this general rule to limit the excepted activities to those specifically outlined. In doing so, Congress determined that in order for the partnership to deal with one of its partners as an "outsider" the transaction dealt with must be something outside the scope of the partnership. If, on the other hand, the activities constituting the "transaction" were activities which the partnership itself was engaged in, compensation for such transaction must be treated merely as a rearrangement between the partners of their distributive shares in the partnership income. *Pratt v. Comm'r*, 550 F.2d at 1026.

*Cagle v. Comm'r*, 63 T.C. 86 (1974), aff'd, 539 F.2d 409 (5th Cir. 1976), and then Congress in 1976, made it more or less clear that Section 707(c) expenditures were subject to the "origin-of-the-claim" test, i.e., their tax treatment ((a) ordinary deduction, (b) capitalization and amortization as a separate free standing asset, (c) capitalization with no amortization) turned on the nature of the services provided and what such services related to. Factually most "guaranteed payments" to promoter-service partners in tax shelters would at best be properly characterized as amortizable partnership start-up cost, formation costs, or additional acquisition costs of depreciable or amortizable partnership assets, and at worst as non-amortizable syndication costs, thus yielding less or no tax benefits to the other non-service partners. See Note, Receipt of a Partnership Profits Interest for Services: St. John v. United States and a Suggested Solution, 5 Va. Tax Rev., 127, at 151 n.170 (1985). Consequently, in some cases treatment of the payments for management services as a distributive share of net (or even gross income) produced prior to 1984 better tax results to non-service partners than would non-currently deductible "guaranteed payments" by reducing the non-service partners' share of net income (or increasing their loss in loss years if the allocation were of partnership gross income). See *Passthrough Entities Hearings, supra* at 66 (Ginsburg); *Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms before the House Ways & Means Comm., 98th Cong., 2d Sess. 9 (Ass't Sec'ty Chapoton) (1984) (*Tax Shelter Hearings*).

As the tax sheltered taxpayer's preferred tax posture shifted from "guaranteed payments" for such management services to "distributive share", the Service too flip flopped. In Revenue Ruling 81-300, 1981-2 Cum. Bull., the Internal Revenue Service disagreed with the Tax Court's conclusion in *Pratt* that the payments were not Section 707(c) payments, since measured by gross income. "It is the position of the Internal Revenue Service that in *Pratt* the management fees were guaranteed payments under Section 707(c) of the Code. On the facts presented, the payments were not disguised distributions of partnership net income, but were compensation for services payable without regard to partnership income." At the same time in Revenue Ruling 81-301, 1981-2 C.B. 144, the Service buttressed *Pratt's* Section 707(a) analysis by possibly limiting the predecessor to Section 707(a)(1)'s non-partner capacity transactions to those where the partner's services for the partnership in question were substantially the same as services it rendered as an independent contractor or as an agent for others. In Revenue Ruling 81-301 the partner receiving the payment in question, an investment advisor, was
personally liable for partnership losses incurred in investments made pursuant to his services or advice, incurred his own expenses in rendering advice (including office expenses and personnel expenses), and could be removed by a majority vote of the other partners.

Congress apparently concluded that Revenue Ruling 81-300 was insufficient to channel partnership payments to partners for services that would not be currently deductible, if paid to third parties, into Section 707(c) classification and, accordingly, in 1984 enacted Section 707(a)(2)(A), which provides for regulations treating a transaction as a Section 707(a)(1) non-partner capacity transaction (and hence subject to the "origin-of-the-claim" test, but not to the special accrual rules of Section 707(c)) if (a) the rendition of the services or transfer of property by the partner, and the (b) a related direct or indirect partnership allocation viewed together with the distribution are "properly" so characterized. I.R.C. § 707(a)(2)(A).

Congress did not intend for new Section 707(a)(2)(A) to override Section 721 or to apply to an allocation to a partner for an extended period to reflect his/her contribution of property or services to the partnership where the such allocation was received in his/her capacity as a partner. S. Print. No. 169, supra at 226. See Hearings on High-Income Taxpayers and Related Partnership Tax Issues before the Subcommittee on Oversight of the House Committee on Ways and Means, 99th Cong., 1st Sess. 295 (1985) (Aronson). Congress' goal was "transactions that worked to avoid capitalization requirements or other rules and restrictions governing direct payments...", e.g., "allocations used to pay partnership organization or syndication fees..." Id.; Tax Shelter Hearings, supra at 226.

Congress sketched, six, nonexclusive, factors for "determining whether the partner is receiving the putative allocation and distribution in his capacity as a partner." S. Print. No. 169, supra at 226. The first, and generally most important, factor is whether the partner's allocation-cum-distribution is subject to significant entrepreneurial risk to the recipient partner as to the amount and fact of payment. Id. at 227. Short-term, gross income allocations would be particularly suspect here, since (a) less risk, (b) transitory, and (c) close in time to the performance of the services (the latter two elements also constitute negative criteria considered by Congress). Id.

In summary, in order to determine the proper characterization of the payment a two-step analysis is often necessary. The first question is whether the services were performed or property, etc., transferred in the partner's capacity as a partner. If not, Section 707(a)(1) would apply if the service provider or transferor were otherwise a partner. On the other hand even if the services were provided in the service provider's or transferor's capacity as a partner, the payment can take on a non-partner characteristic, i.e., Section 707(c) status as a guaranteed payment or Section 707(a)(2)(A) equivalent of a "fee", if the payment terms manifested sufficient non-partner characteristics as to certainty of payment. As to this latter question new Section 707(a)(2)(A) often, if not always, should be determinative.

iv. Compensatory Profits Share

The conventional approach (Diamond, etc.) as to a profits interest received for service constitutes perhaps the most severe aggregate-entity conflict, since largely unrecognized.
(A) Interest in Capital Contributions of Others

Clearly if a taxpayer receives an interest in the capital contributions of the other partners in exchange for services to the partnership, past or future, the exchange of the services for the partnership capital interest does not come within the nonrecognition umbrella of Section 721. Treas. Reg. § 1.721-1(b)(1). Rather payment of the capital interest for services rendered to the partnership is treated as a Section 707(c) guaranteed payment, namely, a transfer by the partnership of an undivided interest in partnership assets to the service partner for his/her services followed by his/her recontribution of such undivided interest to the capital of the partnership. The deduction, if any, to the partners for such payment must be allocated to the other partners under Section 706(d)(2). See Note, supra, 5 Va. Tax Rev. at 151 n.170. The partnership would generally have a stepped up fair market value basis therefore in that portion of its assets deemed recontributed to the partnership by the service partner. Although not covered by the Section 704(c) regulations, equity and arguably the assignment of income doctrine would require that the partnership assets and capital accounts be revalued upon this transaction, and differences between the other partners' outside basis and the partnership's inside basis should be taken account of under Section 707(c) principles.

The Section 721 regulations do not address the transfer of an interest in the other partners' capital contributions for services to such other partners, rather than to the partnership. However, McDougal v. Comm'r, 62 T.C. 720 (1974), achieves much the same affect as a constructive sale to the partner followed by recontribution approach for services rendered to the partnership. Such a transaction is treated as a transfer by the capital partner of an undivided interest in the partnership assets in exchange for the past services, resulting in recognition by the service partner and the capital partner, followed by a contribution by the service partner of his/her undivided interest in the assets to the partnership. If a new partnership is involved, the transfer by the capital partner would probably trigger Section 704(c).

(B) Profit-Share for Future Services

If a taxpayer receives a "profit share" for performing future services to the partnership, the essential issue is whether such "future partnership payments" constitute a distributive share under Section 704 or a payment to a non-partner under Section 707(a)(1). In the case of such a payment to a non-partner, Section 83 would apply to require inclusion of income as soon as the partnership interest becomes nonforfeitable.

If a "profits interest"-cum-distribution is neither capped nor floored and is received for future services with both the profits interest and the services continuing for some period, the allocation and subsequent distribution constitute a Section 704 distributive share and Section 731, etc. distribution and neither a Section 707(a) non-partnership capacity payment, Section 707(c) guaranteed payment, nor a Section 707(a)(2)(A) deemed non-partnership capacity where payment involves entrepreneurial risk, etc. Where the allocation and distribution constitute such a distributive share and accompanying distribution, the partner is taxed under Sections 702(a) and 704(a) or (b), in the partnership tax year in which the allocation is effected rather than in the year in which the partnership profit share is received.
(C) Past Services on Own Behalf

Stafford v. United States, 727 F.2d 1045 (11th Cir. 1984) and St. John v. United States, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983), involve more extensive promotional services than did Diamond v. Comm'r, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974), but all three decisions were on the same spectrum of value created by services. Stafford by its more extensive services would seem even more in contradiction to the Diamond principle that a profits interest received for services constitutes a taxable transaction (where the profits interest can be valued). Stafford, however, found that the value created by the promoter, here a letter of intent, constituted property and hence came within Section 721. The underlying policy here is preventing a service renderer from converting service created value into capital gain, Lane, Sol Diamond: The Tax Court Upsets the Service Partner, 46 So. Cal. L. Rev. 239, 252-58 (1973). Stafford would appear to be contrary to this policy, unlike Diamond. The same policy can be seen in the legal fiction chosen by the Tax Court in Hale v. Comm'r, 24 T.C.M. 1497 (1965), a pre-Diamond services case, where the Tax Court denied capital gains to the sale of a profits interest on the grounds that it was merely a future income carve out denying capital gain under P.G. Lake, Inc. v. Comm'r, 356 U.S. 260 (1958).

Other 1984 amendments to the partnership provisions (coupled with Section 707(a)(2)) supply an approach that reconciles Stafford with the underlying policy of prevention of conversion of income and at the same time provides a mechanism for taxing the service partner at a better time, namely disposition of the partnership profits interest or a disposition by the partnership of the underlying value created by the services partner. Under new Section 724, if the property transferred by the services partner would have yielded ordinary income if sold by him/her, then such value constitutes a "inventory" item as to the transferor partner, and hence an inventory item to the transferee partnership. Consequently, if the partnership sells this value (within 5-years) it will result in ordinary income which must be allocated, due to the difference between basis to the transferor partner—zero—and value, to the transferor partner under Section 704(c). Section 724 taints such "inventory items" as to the partnership and partner for only five years. Similarly, if during this initial five year period the service partner sold his/her partnership profits interest, Section 724 coupled with Section 751(a) would equally result in ordinary income to the service partner. For this conceptual framework to work the value created by the service partner should not be added to the basis of say a Section 1231 asset, but treated as a free standing asset, yielding ordinary income. Cf. Lee, Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform and a Touch of Basics, 6 Va. Tax Rev., 1, 32-38. As to whether a sale by the service partner of such created value would yield ordinary income, the cases are a bit split. Some jurisdictions allow extensive efforts by the taxpayer to still yield capital gain where but a single sale is involved. Comm'r v. Williams, 256 F.2d 152, 155 (5th Cir. 1958). Other transactions look more to the overall business of the taxpayer and the efforts involved importing a more or less products of efforts approach. Bush v. Comm'r, 36 T.C.M. 340 (1977), aff'd, 80-1 U.S.T.C. ¶ 9118 (6th Cir. 1979).
(D) **Past Services on Behalf of Partnership.**

The Eleventh Circuit in *Stafford* was careful to point out that the ownership rights in the letter intent in question lay with the service partner and not with the partnership.

If the partnership owned the letter of intent, Stafford could not be said to have contributed that letter because it was not his to give. Thus, Stafford would not be eligible for nonrecognition under § 721 on his receipt of the third partnership share [Stafford bought two other partnership shares for cash]. A detailed examination of the record and the application of the legal principles set forth in *James* leads us to conclude that Stafford owned the letter of intent and it was his property to contribute to the investment vehicle of his choice. 727 F.2d at 1049.

*Stafford* relied upon a Section 351 decision, *James v. Comm'r*, 53 T.C. 69 (1969), where the taxpayer providing services entered into a contract with the capital providers whereby the service provider agreed to secure necessary legal and architectural work and arrange for a financing of a rental apartment project on the capital supplier's land. Upon completion of the project, the landowners would transfer their land to a corporation which would then issue stock both to the landowner and to the service provider. The stock issued to the service provider was purportedly received in exchange for a loan commitment for the financing of the project. The loan commitment ran in favor of the corporation because the lenders' regulations permitted commitments only to corporations and not to individuals. In the corporate context Section 351(d) and predecessor provisions clearly state that "services" do not constitute property for purposes of Section 351 which also requires a property transfer. However, the explicit statutory exclusion of "services" from the term "property" apparently achieved the same result as pre-1954 case law. *James v. Comm'r*, 53 T.C. at 67, citing an early edition of Bittker & Eustice. And the Tax Court in *Diamond* pointed to the pre-1954 Code history of the predecessor to Section 351 where case law without any specific statutory authority had established that "services" did not constitute "property" for purposes of the predecessor of Section 351. 56 T.C. at 545 n.14.

However, under a deep structure analysis the similarity between Sections 721 and 351 in this context disappears. The true policy reason for not classifying services as property for Section 351 purposes is that otherwise the service provider can convert his/her services into a stock interest in the corporation which then could be sold at capital gains rates, due to the entity approach to corporations (C or S). *Lane*, supra. The collapsible corporation provisions discussed below only infrequently retard this conversion of the services into capital gains. On the other hand, as discussed above Sections 704(c), 724 and 751 produce the proper character and timing: ordinary income to the service partner but only upon a disposition by the partnership of the value created by him/her or upon a disposition of the partnership interest (during the five-year taint period of Section 724). Therefore, on a policy basis past services for the partnership should generally be treated the same as past services on the service provider's own behalf transferred to the partnership.
True, casting the analysis in terms of what did the service provider transfer to the partnership if the partnership already owned the developmental rights superficially creates conceptual problems. However, Section 707(a)(2)'s legislative history directs the regulations to provide "that persons who become partners after performing services for ... the partnership are to be treated as partners." S. Print. No. 169, supra at 232; see also id. at 227 (first paragraph). The 1984 Bluebook explains that such service providers will immediately be treated as partners for purposes of Section 707(a)(2) even though they "formally" become partners later. Thus, under the emerging approach of Section 707(a)(2) the question is twofold: were the services of the sort that would be performed by a partner within his/her capacity as a partner and, if so, was the form of payment a "distributive share" or a more risk-less payment. Under this analysis in most cases the service provider would be a partner performing services within the scope of employment and the "payment" would constitute a Section 702 distributive share, followed by distribution. As further discussed below, where the service provider "materially participates," the partnership should be treated as an aggregate to yield as close an approximation to "direct taxation" as possible.

v. "Guaranteed Payments" Under Section 707(c): What's Left?

The majority view is that Section 707(c) applies only to transactions that qualify on the transfer/performance side of the transaction as partnership capacity transactions (a la Pratt and Otey). See Leder, Guaranteed Payments, Management and Promoters, 41 N.Y.U. Inst. on Fed. Tax. 14-1, 14-13 (1982); McKee, Nelson & Whitmire, supra at ¶ 13.01. Contra Cowan, Compensating the General Partner: "The Pratt Case", 56 Taxes 10 (1978). Otherwise the non-partner capacity transaction-oriented Section 707(a)(1) would apply. Again the bright line test is whether the transfer is of an essential asset or a sporadic, not essential asset transfer and in the case of services, etc. whether the performance is continual or essential to the business.

The second Section 707(c) element is the "payment's" determination be "without regard to the income of the partnership." Cases have derived from Section 707(c)'s focus on the manner in which the payment is determined an underlying policy of distinguishing between (a) Section 704 entrepreneurial risk payments, actually Section 704 distributive share cum-Section 731(a) distributions, and (b) Section 707 payments, on the basis of "whether payment by the partnership to the partner is at the risk of the economic fortunes of the partnership." Otey v. Comm'r, 70 T.C. at 320. Thus, the essence of Section 707(c) is (1) a partner capacity transfer accompanied by (2) a non-partner capacity payment. This, as we have seen also constitutes the core of a Section 707(a)(2) transaction; (a) partner capacity transfer and (b) a distributive share of income/gain-cum-distribution or distribution alone which are the equivalent of a direct payment or sale not at the risk of the fortunes of the partnership. Thus the question arises as to how to distinguish a Section 707(c) guaranteed payment from a Section 707(a)(2) transaction. Two easy distinctions are that Section 707(c) applies to payments to a partner for the use of capital whereas Section 707(a)(2) does not. Conversely, Section 707(a)(2) applies to transfers of property to the partnership whereas Section 707(c) does not. The difficult area is that payments for services to which both apply.
A tight reading of Section 707(a)(2)(A) and Section 707(c), together the legislative history of Section 707(a)(2)(A), which manifests that Congress was "concerned with transactions that worked to avoid capitalization requirements or other rules and restrictions governing direct payments...", S. Rep. No. 169, supra at 226, indicates that the key distinction is the form of the payment. In the case of a 707(a)(2)(A) payment the form of the payment is an "allocation" and "distribution", when the substance of the performance of the partner-capacity services plus the allocation-cum-distribution is a direct payment for the services. In contrast in Section 707(c) the form and the substance are the same: a direct payment. Thus where the form is a payment and the services are partner-capacity services Section 707(c) applies. If the form is a payment but the services are non-partner capacity services, then Section 707(a)(1) applies. If the form of the payment is a distributive share-cum-distribution, but the substance is a non-partner capacity payment for partner capacity services, then Section 707(a)(2)(A) applies. Presumably Section 707(a)(2)(B) never applies to a performance of services, but only a transfer of property. Were Section 707(a)(2)(B) to apply, there would be no means of distinguishing Section 707(a)(2)(B) from Section 707(c) because Section 707(a)(2)(B) does not speak of the form of transfer in or transfer out, but rather the broader term transfer which would cover transactions both cast as a sale and cast as a Section 721 transaction.

Apparently the conflict between the Service and the Tax Court in Pratt as to whether a distributive share-cum-distribution based upon partnership gross income constitutes a "guaranteed payment" has been resolved in favor of the Pratt exclusion from guaranteed payments by treating the issue instead under Section 707(a)(2)(A), which is entirely proper since payments depended upon gross income may or may not reflect partner-risk as to the fact and amount of payment. See Leder, supra 41 N.Y.U. Inst. on Fed. Tax. at 14-9-14-12.

Since both Sections 707(a)(2)(A) and 707(c) are aimed at the same substantive transactions (although cast in opposite form) the important question is the distinctions in treatment under Sections 707(a)(1) and 707(c), since Section 707(a)(2) transactions are treated as deemed Section 707(a)(1) transactions. The differences are (a) timing of inclusion and deduction and (b) the character of income. In the case of a guaranteed payment, the partner must include the payment as ordinary income in his/her taxable year with, or within, which ends the partnership's taxable year in which the partnership deducted such payments. Treas. Reg. § 1.707-1(c). Interestingly, the timing of the partnership's deduction turns on when the partner includes the amount in income. The bottom line is that a Section 707(a)(1) payment is includable in income by the partner in accordance with his/her own method of accounting, generally cash, which means when received, see Leder, supra 41 N.Y.U. Inst. on Fed. Tax. at 14-18, and the partnership gets a deduction only at that time. Conversely, because a partner picks up, notwithstanding the cash method of accounting, a guaranteed payment as income in the year in which the partnership accrues it, the partner has income in that earlier year and the partnership has a deduction in that year. Thus, Section 707(c) can accelerate both income and deduction.

The Section 707(c) payment carries ordinary income status and carries with it non-partner capacity status but only for purposes of Sections 61 and 162. Conversely, Section 707(a)(1) payments are also ordinary to the
recipient, but carry with them third party status for all purposes of the Code. Leder, supra 41 N.Y.U. Inst. on Fed. Tax. at 14-18.

Existing Section 707(c) regulations take the position that a "minimum guarantee", i.e., "where the partner has a general profit percentage, but is guaranteed a minimum amount [.] . . . the guaranteed amount is a guaranteed payment only to the extent it is greater than the amount the guaranteed partner would have received solely by application of his general profit percentage." Leder, supra 41 N.Y.U. Inst. on Fed. Tax. at 14-17; Treas. Reg. § 1.707-1(c), ex. 2. Leder argues that this provision is at odds with the legislative history to the 1954 Code. See Leder, supra 41 N.Y.U. Inst. on Fed. Tax. at 14-7, n.12. Be that as it may, clearly application of such a rule would allow subversion in part of the purpose of Section 707(a)(2). In other words if the payment for the partner—capacity services is structured as a distributive share cum distribution and Section 707(a)(2)(A) applies, the entire distributive share cum distribution is treated as a direct payment. Conversely, if the payment is cast as a general profit percentage with a guaranteed minimum payment, only the excess of the minimum payment over what the general profit percentage would have yielded is treated as a direct payment under Section 707(c). The distributive share that the partner would have received any way obtains distributive share treatment. Yet, economically it is not at risk. One might expect Treasury to address this anomaly and discontinuity under the directive that existing Sections 707 (and 736) regulations be reviewed in light of the policies of Section 707(a)(2)(A).

b. Subchapter S

i. Introduction

Subchapter S contains no analogue to Section 707. Moreover, conventional doctrine holds that the businesses of a corporation (including an S corporation) and of its shareholders are separate. Whipple v. Comm'r, 373 U.S. 193 (1963). And a shareholder has no obligation to contribute "essential services or property to his/her corporation. Therefore, if an S shareholder performs services for his/her S corporation and is paid, the issue theoretically cannot be whether the performance was in a "partner" capacity or whether payment was subject to entrepreneurial risk (unless a note were received). Instead the only tax issues are whether the compensation was "reasonable" under Section 162(a) or whether the payment was for services or constituted a constructive dividend.

The Joint Committee Staff in its 1980 Subchapter S Revision Recommendations focused a narrow aspect of owner-entity compensation arrangements: incorporation of investments and "compensation" payments by the S corporation to the owner for managing the investments. It proposed to reduce compensation to S shareholder -- employees in the proportion that the S corporation's "passive income" bore to gross receipts if such income exceeded a 20% of gross receipts floor. Staff S Recommendations, supra at 20. This provision dropped out by the 1982 revisions.

Section 1366(e) does provide for adjustments to the S's passthrough of items to be taken into account by its shareholders where a "member of the family" of one or more S shareholders renders services or furnishes capital to the S Corporation without receiving "reasonable compensation". But this
provision is thus limited to family S Corporations like the family partnership rules of Section 704(e).

ii. **Compensatory Profit Share.**

Again this is an area in which there are no special S corporation rules and instead the general C corporation entity rules apply. I.R.C. § 1371. Under those rules neither past nor future services on behalf of the S corporation constitute property for purposes of Section 351. I.R.C. § 351(d). Thus, in those two instances the service provider would recognize gain or loss upon receipt of the stock, subject to the rules of Section 83.

This leaves the Stafford type transaction of services on behalf of the service provider rather than of the corporation creating a property interest which is transferred to the S corporation. While Stafford would sanction treatment of, for example, a letter of intent as property for Section 351, on a policy basis this produces the wrong result. For a subsequent sale of the stock would generally yield capital gains, unless the collapsible corporation provisions apply. Most tax shelter operations if conducted in corporate form, particularly of rental property, would probably constitute collapsible corporations. Then the question is whether the escape hatches of Sections 341(e) or 341(e) can be availed of. Essentially the latter provision lets an otherwise collapsible corporation out from under the collapsible provisions (which convert what would otherwise be shareholder level capital gain into ordinary income, I.R.C. § 341) where neither the corporation nor substantial shareholders are "dealers" or "hypothetical dealers" as to the S corporation's assets. In the typical rental operations, the corporation presumably holds the property primarily for rental and not for sale. Malat v. Riddell, 383 U.S. 569 (1966). The Corn Products doctrine might produce a different result. Turning to the shareholder level, a different result obtains according to whether the shareholder is (a) a more than five percent, but not more than twenty percent shareholder, or (b) a twenty percent or more shareholder. The former is tainted only if in his his/her own right he/she is a dealer, the latter is subject to a "hypothetical dealer" test which would apply in many instances. In short, the service provider may in some instances be able to obtain capital gains, contrary to the pattern of the partnership provisions. Accordingly from a policy point of view Stafford's analysis should not apply to a transfer to a controlled S corporation.

2. **Loans**

a. **Subchapter K**

i. **Introduction**

The Senate Finance Committee extended in the 1954 Code with scant explanation Section 707(c) "guaranteed payment" treatment to a partnership's payments of interest on partner loans to it to the extent such interest payments were determined without regard to partnership income. S. Rep. No. 1622, supra at 92, 387. The cases, however, have not explored whether a partner's loan to the partnership constitutes a non-partnership capacity advance of capital. Presumably this should turn, at least in part, on whether the loan was in the scope of the partner's activities, cf. Pratt v. Comm'r, supra. Furthermore, with the advent of Section 707(a)(2) the question arises whether the partnership's repayment was subject to entrepreneurial risk.
ii. Debt-Equity.

(A) Introduction

Debt-equity arises in 2 partnership contents: (a) "sale" of property to the partnership for a note and (b) advance of capital to the partnership. Treas. Reg. § 1.721-1 treats a partner's transfer of property to a partnership for "a promissory obligation fixed in amount and time for payment... as a sale or exchange under Section 707 rather than as contribution under Section 721." Notwithstanding conventional wisdom that traditional C corporation debt-equity principles apply in Subchapter K, an approach, like Section 707(a)(2), focusing on entrepreneurial risk to payment should be taken. See Gibson Prods. Co. v. United States, 637 F.2d at 1047-49.

ALI took a more black-letter approach:

"Under Proposals . . ., a transaction will generally be treated as a sale if, at the time of transfer of property to a partnership or of a shift in partnership interest, the transferring or diluted partner has received money or other property . . . or is reasonably certain of receiving such money or other property. The determination of whether the receipt of money or other property is reasonably certain is factual one. However, if the receipt by its terms and in fact will come solely from the operating cash flow of the partnership earned after the transfer, it will not be considered to be reasonably certain under the Proposal, if it is highly likely that the cash flow will be earned. On the other hand, the receipt of money or other property will generally be considered to be reasonably certain if the documents contained an obligation to pay or transfer such money or other property on a fixed schedule, and in all events, whether or not such payment schedule extends beyond the 24-month period provided for in the Proposal . . .[the genesis of the three-year presumption in the legislative history."

ALI, supra at 187.

(B) Conventional Wisdom

Conventional wisdom and the handful of precedents considering the issue have held that a promissory obligation in form may constitute in substance an equity contribution under more-or-less traditional debt-equity principles derived from the corporate arena. See McKee, Nelson & Whitmire, supra at ¶ 3.03[3]; ¶ 4.07[4]; and especially ¶ 7.02[2] and cases cited therein. The most extensive analysis of the application of (corporate) debt-equity analysis to Subchapter K of the 1954 Code without question, notwithstanding Section 707, which has no 1939 Code counterpart. Kingbay v. Comm'r, 46 T.C. 147 (1966). Ironically, there the taxpayer (a limited partner) argued, in the context of Section 752 and sharing of liabilities, that loans by
the principal shareholder of the corporate general partner to the partnership for which such general partner was personally liable should be considered contributions by him to the capital of the partnership under the Hambuechen incorporation of corporate debt-equity criteria. The Tax Court in determining whether the advances were in reality capital contributions to the partnership and not loans, applied traditional corporate debt-equity criteria. Kingbay restated approvingly the Hambuechen criteria:

[Whether a particular transaction creates a valid debtor-creditor relationship or is in reality a contribution to capital is a question of fact to be determined from all the surrounding circumstances with the burden of proof on the taxpayer. Such factors as the adequacy of the capitalization of the debtor, the issuance of notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the debt is subordinated to claims of outside creditors, presence or absence of security for the loan, reasonableness of expectation of repayment, use to which the funds were put, are among those to be considered in making the determination. 46 T.C. at 154.]  

Rigorous analysis of the corporate debt-equity cases boils these down to essentially four mega-factors:

1. Proportionality

2. Excessive Debt or "Thin Capitalization"

3. Essential Assets, discussed more fully below, generally used more in the context of sales of appreciated property to a controlled entity than with fresh capitalization used to acquire initial operating assets from outsiders; and

4. Intent, which often really means that there is substantial economic reality, i.e., an outside creditor would make the loan, or whether there has been in fact actual enforcement of the terms of instrument when due. See generally, Plumb, Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, pp. 4-10-4-15 (1979).

Hambuechen, however, followed the above laundry list of factors with the "apt" statement that "the essential difference between a creditor and a shareholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event." 43 T.C. at 99. And, the Tax Court concluded that the advance made by the taxpayer "was intended to be subject to the risk of the business and not repayable in any event." 43 T.C. at 105. Nevertheless, Hambuechen at the same time balanced its "risks of the venture" policy with a statement indicating that "reasonable expectation of repayment," as contrasted with placing the advances "at the risk of the business," constitutes a significant factor, "[a]lthough no one factor by itself is determinative." The Hambuechen court believed that it was applying a "substantial economic reality" test. Id. at 104. "It had been stated many times that the form the
transaction takes is not controlling, but rather the 'substance'". 43 T.C. at 90.

The taxpayer in Hambuechen argued that the court should not use the corporate debt-equity factors, but did not "enlighten" the court as to what test or factors to be used.

We can see no valid reason why, once it is necessary, for tax purposes, to determine the existence of a debtor-creditor relationship, such determination must be made upon different factors or criteria depending upon who the debtor and creditor are and the relationship to each other. 43 T.C. at 101.

(C) Preemption by New Section 707(a)(2)

Recall that Hambuechen was a 1939 Code case and there was no analogue to Section 707 under the 1939 Code (and partner capacity and outsider-like dealings issues created a great deal of confusion under the 1939 Code. See Cowan, Compensating the General Partner; The Pratt Case, 56 Taxes 10 (1978)). Thus the question must be asked whether Section 707 as enacted or Section 707(a)(2) preempt the area. For the policies underlying Section 707, especially Section 707(a)(2), parallel the underlying policies judicially fashioned in the partnership debt-equity arena: economic effect and expectation of repayment versus an advance "intended to be subject to the risk of the business and not repayable in any event." Hambuechen v. Comm'r, 43 T.C. at 105. Therefore, if the partnership debt-equity issue at least in the "disguised equity contribution", "sale" form context can be brought within the framework of Section 707, then arguably the regulations, particularly under Section 707(a)(2), should preempt further case-law development. Section 707(a)(1) often would not apply directly even if the debt were recognized as debt, since its scope is limited to non-partner capacity transfers and often the purported sale is of essential operating assets; hence, a partner-capacity transfer under Otey. At the same time Section 707(c) would usually be inapplicable to credit "sales" or property transfers for a note since it supplies "guaranteed payments" treatment to partner capacity transactions, but only in the case performance of services and return on capital invested. This leaves Section 707(a)(2) in the "sale" context, but in the pure loan context (note for cash) Section 707(c) would apply.

Section 707(a)(2)(A) clearly cannot apply. It recharacterizes as a transaction occurring between a partnership and a partner acting other than in his capacity as a member of the partnership, i.e., as a direct fee or sale, a partnership allocation cum distribution and the performance of services for, or transfer of property to, the partnership having "the substantial economic effect of direct payments for such property or services. ...." S. Rep. No. 169, supra at 226. It does not, however, provide for the reverse, treatment of a purported direct payment as in economic effect a partnership allocation and distribution where the allocation (cum distribution) is subject to significant entrepreneurial risk. Moreover, the policy underlying Section 707(a)(2)(A) is inapplicable to a debt-equity question. The Senate Finance Committee was "concerned with transactions that work to avoid capitalization requirements or other rules and restrictions governing direct payments. ...." Id. at 226.
Section 707(a)(2)(B) is more problematical. Unlike Section 707(a)(2)(A), subparagraph (2)(B) refers only to a "transfer of money or property into the partnership and a related transfer of money or other property from the partnership to the partner (or another partner in the case of a partner to partner disguised sale or exchange) where such transfers, "when viewed together, are properly characterized as a sale of property." The purpose of Section 707(a)(2)(B) is to prevent the parties from characterizing what is in economic effect a sale or exchange of property as a tax-free Section 721 contribution to the partnership followed by a tax-free Section 731 distribution from the partnership in order to avoid or defer tax on the transaction. S. Rep. No. 169, supra at 230. Conversely, if the transaction does not substantially resemble economically a sale or exchange of all or part of the property, then the contribution comes under Section 721, and not Section 707, and the payment out will be a distributive share and not a deemed nonpartner capacity transaction, i.e., sale. See Otey v. Comm'r, 70 T.C. at 319.

As discussed above Section 707(a)(2)(B) rests on the assumption that the "transfer" in is in a partner capacity. The issue then is whether the payment by the partnership to the partner is at the risk of the economic fortunes of the partnership, Otey v. Comm'r, supra at 230. In short, therefore, Section 707(a)(2)(B) can form the framework for regulations determining whether the transfer of money or other property, including the promissory note by the partnership to such partner plus the transfer of money or other property to the partnership, when viewed together, are properly characterized as (a) a sale of property, or (b) a tax-free contribution of property, followed by a generally tax-free distribution. Such regulations should preempt the case law debt-equity approach (much like the Section 482 preemption of Section 61 assignment of income doctrine where both overlap, see, e.g., Haag v. Comm'r, 88 T.C. No. 32 (March 16, 1987)).

Unfortunately, however, Section 707(a)(2)(B)'s legislative history offers scant guidance as to when a transfer in-cum-transfer out economically resembles a sale rather than an equity contribution-cum-distribution, in contrast with Section 707(a)(2)(B) legislative history which details common factors militating towards entrepreneurial risk. But as discussed below, the loan-proceeds distribution and deficit-restoration discussion indicate that where the "payment" is made in fixed form, the issue is the probability that the partner may retain the distributed property (cash distribution). Analogously with a note payment, the question is the probabilities of actual payment. For this reason alone the "objective" approach of the ill-fated Section 385 regulations probably cannot be used.

Several of the traditional corporate debt-equity factors listed by the Tax Court in Hambuechen are directed to the reasonable expectations of repayment versus subject to the risks of the venture: Reasonableness of expectation of repayment, use to which the funds were put, and whether payment can only be made out of future profits..." 43 T.C. at 99; accord, Kingbay v. Comm'r, 46 T.C. at 154. The reasonableness of expectation of repayment has traditionally focused in large part on "source of payments". See Plumb, 26 Tax L. Rev. supra at 526. Generally, a source of repayment analysis becomes important where the shareholder advance to her/his corporation is used to acquire essential operating assets, or perhaps even more frequently where such assets are transferred by the shareholder to the corporation in exchange for the purported debt. Id. at 522. The character of
such essential operating assets narrows the sources from which payment reasonably may be expected. Id. at 522, 526. Generally, a corporation has four potential sources for repayment of shareholder advances: (1) liquidation of assets; (2) profits from operations; (3) cash flow, i.e., excess of receipts over cash outlay; and (4) refinancing of liabilities or borrowing against appreciation in assets. In the corporate context if liquidation (operating) assets is the only source of repayment, generally a strong inference arises that shareholder-creditors would not undertake such drastic action and hence do not "intend" true loan status. Plumb, supra 26 Tax L. Rev. at 526. A different story is presented by a real estate development business which gradually does liquidate its original assets, unless substantial additional funds were needed to develop such assets for resale. See, e.g., Aqualane Shores, Inc. v. Comm'r, 269 F.2d 116, 119 (5th Cir. 1959). A bona fide third party purchase offer has been bootstrapped into a source of repayments on the grounds that the properties contain self-liquidating potential. Bradshaw v. United States, 683 F.2d 365, 375 (Ct. Cl. 1982). Profits on the other hand constitute an excellent source for repayment of "debt" unless speculative in an untried business. Plumb, 26 Tax L. Rev. 527-28. Projected cash flow adequate to retire the purported debt according to its own terms is the most meaningful criterion of economic reality. Id. at 528-29.

A final, perhaps minor factor in the corporate debt equity context is a "core" or "essential assets" risk analysis which superficially appears substantially similar to the Otey partner capacity analysis focusing on whether the transferred property was essential to the purpose for which the partnership was formed. The corporate debt-equity argument here runs that where purported debt was issued (a) in exchange for funds used to acquire essential operating assets, under an economic substance analysis such assets by their very nature are placed at the risk of the business and manifest a continued proprietary interest due to the high degree of risk which is the essence of an equity interest. See Plumb, 26 Tax L. Rev. at 520. Some commentators argue that because loans from outsiders can be used to purchase essential assets, loans from shareholders or transfers from shareholders for the same purpose are permitted so long as expectation of payment is reasonable. Bittker & Eustice, supra at 14-13-14-14. The reality appears to be that substantially "pro rata" to a corporation with substantial debt, shareholder advances used for core assets or core assets transferred for corporate notes require a very certain source of payment aside from speculative profits, ability to self liquidate the core assets, etc. Compare Bradshaw v. United States, 683 F.2d at 373; Plumb, supra 26 Tax L. Rev. at 520-22.

In Otey, however, the transfer of the essential operating asset by the partner was a factor in determining whether the transfer was in the partner's capacity. There the property was a part of the raison d'être of the partnership formation. Essential operating asset was not a factor here as to probability of repayment, but rather was relevant to the role the partner was to play in the partnership. Since the Section 707(a)(2) legislative history relegates determination of partnership capacity transfer to a very subordinate role, the fact that operating assets are transferred for the purported note might not be a major factor in itself as to whether the note constitutes debt or equity. Furthermore, since this aspect is encompassed by the first step of the two-step analysis, it should not play a major role in the second factor unless it truly significantly lessens the probabilities of repayment.
Partnership debt-equity issues raise a problem that does not arise in corporate, including S corporation, debt-equity issues. A partner's equity contribution is includable only in her/his basis under Section 723, but a recourse or nonrecourse loan to the partnership by the partner is shared as a partnership liability by the other partners under the Section 752 rules. Not surprisingly with the proliferation of tax shelters, in recent years partnership debt-equity controversy has arisen in this Section 752 arena. The opening salvos were Revenue Rulings 72-135, 1972-1 Cum. Bull. 200, and 72-350, 1972-2 Cum. Bull. 394. Revenue Ruling 72-135 flatly states that a non-recourse "loan" from the general partner to a limited partner (in a limited partnership engaged in the acquisition, exploration, development, and operation of oil and natural gas properties) or to the partnership constitutes a contribution to the capital of the partnership by the general partner, rather than a loan. Consequently, the nonrecourse liability in the case of a purported loan to the partnership could not be shared by the limited partners and amounts lent to them by the general and then contributed to the partnership were not included in their basis either. The probabilities of repayment, and hence who would bear the ultimate risk, was not discussed. Revenue Ruling 72-350 proceeds more along a risk analysis approach. The loan to an oil and gas partnership their was secured by the partner's properties "consisting of some unproven leases and some expensive but virtually unsalvageable oil and gas well installations." 1972-2 Cum. Bull. 395. Additionally, the lender who was not otherwise a partner had the right at any time to convert the loan and receive in exchange a 25 percent equity interest. The lender was not formally a member of the partnership. Revenue Ruling 72-350 concluded that the so called "loan" was not a bona fide debt but "in reality, capital placed at the risk of the venture...." Thus the funds advanced by the purported lender constituted his equity interest in the venture. Therefore the limited partners could not include such purported non-recourse loan in their bases.

Revenue Ruling 72-330 apparently described a common technique in the oil and gas industry for boosting limited partners' bases. See Backar v. Western States Producing Co., 547 F.2d 876 (5th Cir. 1977); Gibson Products Co. v. United States, 460 F. Supp. 1109, 1119 (N.D. Tex. 1978) aff'd, 637 F.2d 1041 (5th Cir. 1981); Dillingham v. United States, 81-2 U.S. T.C. ¶ 9601 (W.D. Okla. 1981). See also Joint Committee, Handbook on Tax Shelters 36 n.9 (April 22, 1976) ("[T]here may be questions as to whether nonrecourse loans made to the partnership [engaged in oil and gas drilling and production] should be treated as debt, which may be used to increase the basis of limited partners, or an equity investment by the lender which may not be so used."). While the district court in Gibson Products did not resolve the debt equity question since it found the repayment obligation to be too contingent (and the purported liability exceeded the fair market value of the assets), the Fifth Circuit supplied an extensive financial risk analysis approach. 637 F.2d at 1047-49.

True the facts in Gibson Products were extreme with the purported debt exceeding the fair market value of the property so that the case is an abusive tax shelter inflated purchase price decision. Nevertheless, the analysis of reasonable likelihood of repayment in light of all reasonably foreseeable risks
should be the proper focus of a partnership debt-equity analysis. The fact that the question arises in a Section 752 context where the proper analysis is ultimate economic risk as to a purported partnership liability, should not change the analysis, because likelihood of repayment affects that ultimate economic risk.

b. Subchapter S.
   
   i. Introduction.

   Debt-entity in an S corporation context cannot be directly analyzed on an entrepreneur-like transfer and entrepreneur-like risk as to payment basis. To date, debt-equity in the S corporation context has largely bogged down over the second-class of stock issue, now largely resolved by the "straight-debt" safeharbor of Section 1361(c)(5)(B). Cases have yet to grapple in a broader context with how the S issues differ from C issues. But Portage Plastics Co. v. United States, 486 F.2d 632 (9th Cir. 1973), indicates a receptiveness to looking at Subchapter S policies, or at least the policy of denying particular tax benefits wrongfully taken. 486 F.2d at 637; 470 F.2d at 318 nn. 7 and 9.

   At first blush, just as with partnerships, the most important traditional tax uses of owner-held "debt" (i.e., (1) effecting a single tax on corporate earnings through the inside interest deduction and (2) tax-free withdrawal of investment), other than "locking in character", are met functionally with a lot less hassle through use of the pass-thru provisions of the S corporation tax regime. I.R.C. §§ 1366(a), 1367(a)(1), and 1368(b)(1). See Portage Plastics Co. v. United States, 470 F.2d at 318 n.7. And, if the 1988 rate changes stick, i.e., the capital gains preference is truly eliminated, this lock-in of character advantage disappears as well.

   Below the surface, minor tax advantages maybe found in debt where a "conversion" has occurred or is contemplated. In an S corporation converted from a C corporation, which retains C E&P (C E&P can arise as well in a reorganization by an S corporation that has always been an S), a shareholder cannot withdraw her/his investment and share of retained earnings tax free, except to the extent covered by the Accumulated Adjustments Account ("AAA"). Distributions above AAA constitute ordinary income until C E&P is exhausted. I.R.C. § 1368(c)(2). In such perhaps limited circumstances (perhaps less limited in view of the wave of C to S conversions triggered by the 1986 Code) the principal amount of debt held by an S shareholder can be received by her/him tax free unless such shareholder's basis in such debt has already been reduced by her/his "pro rata share" of the S corporation's losses under Sections 1366(d)(1)(B) and 1367(b)(2)(A), and not restored by a subsequent pro rata share of the S corporation's income under Section 1367(b)(2)(B). Conversely, where an S corporation converts to a C corporation, by termination or revocation of its election under Section 1362(d), the S corporation's debt held by the shareholder then can be used to withdraw her/his investment or perhaps more accurately bailout earnings. See Eustice & Kuntz, Subchapter S at 6-9; Portage Plastics Co. v. United States, 470 F.2d at 318. This ploy lies at the heart of suggested techniques for avoiding the no basis consequence of inside S corporation debt: viz., the shareholder instead borrows and then lends the proceeds to the S corporation. Upon conversion, the S corporation loan still outstanding to the
shareholder serves as the conduit for supplying tax-free principal and interest income offsettable presumably by an interest deduction under the investment interest provisions to the shareholder, or even former shareholder. Similarly, such shareholder loans avoid the no basis consequence of related party loans to the S corporation. See, e.g., Frankel v. Comm'n, 61 T.C. 343 (1973), aff'd, (3d Cir. 1974) in unpublished opinion; Prashker v. Comm'n, 59 T.C. 172 (1972); Lee v. Comm'n, 35 T.C.M. 1157 (1976). See generally Note, Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976) -- Section 1374(c)(2) and the Actual Investment Limitation on NOL Pass Through to Subchapter C Corporation Shareholders, 30 Tax Law. 790 (1977).

Shareholder held S corporation debt may also be important in accomplishing estate freezing objectives, and shifting income or control, which generally in a C corporation would be effectuated by the issuance of preferred stock—prohibited under the second class of stock proviso of Section 1361(b)(1)(D). See Coven & Hess, supra; Portage Plastics, 470 F.2d at 318. As a practical matter generally such debt was issued at the creation of the corporation or for additional cash infusions at or before the conversion, since debt issued for no consideration constitutes a dividend as does debt issued for stock in a recapitalization under the "excess principal amount" rule of Section 356.

S corporation debt issued (disproportionately) to shareholders does provide an "economic preference" or priority over stock investment in the event of the S corporation's business fails. See Eustice & Kuntz, supra at 6-9. Even proportionate held debt, if secured, could come ahead of unsecured outside creditors.

The disadvantages to S corporation debt held by a shareholder as contrasted with further stock investment are substantial and would appear to usually outweigh the limited advantages to S corporation debt. See Eustice & Kuntz, supra at 6-9. First, since pro rata share of income or loss is based upon stock ownership and not stock and debt ownership, breaking one's investment up between stock and debt disproportionately to other shareholders yields a lower share of losses to the extent that the investment is made in debt. See Schenk, Federal Taxation of S Corporations 5-9 (1985). Also, bad debt treatment is substantially adverse as contrasted with treatment of stock assuming that Section 1244 applies. Section 1244 yields an ordinary deduction up to $50,000 (or $100,000 in the case of a joint return). I.R.C. § 1244(b) and (a). In contrast, a worthless debt usually yields short term capital loss under Section 166(d), which in effect limits the deduction, albeit ordinary, to $3,000 a year or the amount of any capital gain if greater. See Schenk, supra at 5-10; Eustice & Kuntz, supra at 6-12. But these problems pale in comparison to the problems that arise if the S corporation cannot meet the debt service on the shareholder-held note. See Eustice & Kuntz, supra at 6-9.

An S corporation which runs into debt service problems as to shareholder debt truly faces the horns of a dilemma. On one hand, the S corporation's failure to make required payments, particularly interest payments, under traditional debt-equity analysis manifests an "intent" to establish an equity relationship rather than a debt relationship, but the negative impact of such failure was substantially lessened if attributable to an unexpected cost. See Plumb, supra, 26 Tax L. Rev. at 526, and 522. Under
the withdrawn, repropose Section 385 regulations (inapplicable to S corporations), a failure to pay interest in a subsequent year rendered an instrument determined (under the objective proportionality, excessive debt, and reasonable rate of interest rules) to be debt in year 1 to be reclassified as equity, or preferred stock, in year 2. Such a "second look" rule was necessary under the regulation's approach since probability of repayment or source of repayment or similar factors were not examined at the time of the first look applying the above objective factors. In short, failure to pay interest at least invites an audit and probably substantially sour the taxpayer's case. That being the case if debt service is impossible, restructuring should be sought. Here the fun really begins.

If the shareholder cancels the S corporation's debt, the S corporation under amendments to Section 108 in response to the Putoma decision recognizes ordinary income, which then passes-thru to its shareholders. See Eustice & Kuntz, supra. On the other hand, if the shareholder contributes the debt to the capital of the S corporation or exchanges it for stock, to the extent that the shareholder's basis is less than the face (a likely event in the case of pass-thru of basis-reducing losses in excess of basis in stock) and the instrument is not a "security", defined in this context as a registered security, Section 351 and Section 118 are barred to the shareholder with resulting recognition, albeit at capital gain. See Eustice & Kuntz, supra. To some degree, however, the conversion of debt into stock is less of a problem than the above commentators point out, in that this would appear an ideal transaction for a recapitalization under Section 368(a)(1), so that the exchange would be tax free and the excess principal amount rule of Section 356(d) course would not be triggered. In any event, the entire area is subject to the nagging uncertainty of the debt-equity rules in general and further the mysteries of their application to S corporations hovers over the entire area, with faint rumblings of the second class of stock danger.

ii. Special S Corporation Rules: Second Class of Stock

I.R.C. § 1361(b)(1)(D) prohibits, as a definitional matter, "small business corporation" status (a prerequisite to electing subchapter S, see I.R.C. § 1361(a)(1)) to a corporation having more than one class of stock. For this purpose "straight debt" is not treated as a second class of stock. I.R.C. § 1361(c)(5)(A). "Straight debt" is defined as any written, unconditional promise to pay on demand or on a specified date a sum certain if the interest rate is not contingent on the borrower's profits or discretion or similar factors, the debt is not convertible into stock, and the creditor would otherwise qualify as an S corporation shareholder. I.R.C. § 1361(c)(5)(B).

While Congress provided the straight debt safe harbor rule as to the second class of stock issue, Congress contemplated that a safe harbor debt instrument might nevertheless be treated as stock under general tax principles accordingly authorized regulations relating to the treatment of these instruments for purposes of applying subchapter S and other provisions of the Code. It is intended that these rules would treat the instrument in such a way as to prevent taxable income on the one hand, and also to prevent unfair, harsh results to the taxpayer. It is anticipated that the safe-harbor instruments will be
treated as debt under subchapter S, so that no corporate income or loss will be allocated to the instruments. Payments on the instruments shall be includable in the income of the holder and deductible by the corporation (subject to the rules added by the bill relating to the accrual of unpaid amounts). Payments on these instruments maybe examined to determine whether the payments represent interest or other income in any situation where the treatment as interest might give the taxpayer an unwarranted tax advantage, such as under the net interest exclusion. S Rep. No. 640, 97th Cong. 2d Sess. 22 (1982).

Outside of the protective umbrella of the straight debt safe harbor, Congress intended that the "usual tax law classification principles" would apply to determine whether the instrument constituted stock or debt. Id. Furthermore, in the case of a C corporation with outstanding debt treated under the general principles as equity, conversion to S corporation status does not constitute a shift as to the purported debt instrument from equity to debt (which would trigger the excess principal amount rules of Section 358), but rather a later redemption of the instrument may be treated as a dividend if the S corporation has remained C E&P. Id.

iii. S Corporation Debt-Equity

(A) Introduction

Where an entrepreneur holds appreciated property which is needed in the S corporation's business, in theory he/she has six choices as to the form of transfer of ownership to the S corporation.

(1) Section 351 contribution for stock
(2) Section 351 contribution for stock and security (or security alone if the transferor is already a stockholder)
(3) Sale, or part sale-part contribution, to the S corporation, including an installment sale.
(4) Section 351(a) and (b), part contribution-part deemed sale since "boot" (cash or short-term note, or other recognition property).
(5) Cross sale of part interest in property to joint entrepreneurs and then joint Section 351 contribution.
(6) Section 357 tainted liabilities and liabilities in excess of basis where the transferor borrows out the equity prior to a transfer subject to the liabilities to the S corporation.

Under the "step transaction doctrine" as well as the concept of economic equivalence, a purported sale to the S corporation (particularly if a part sale-part contribution), a contribution of money to the S corporation followed by its purchase of property from the contributor, and a formal boot note under Section 351(b) should all be treated the same, and usually are.

As indicated above in the discussion of partnership debt-equity, the deep structure analysis corporate debt-equity question is the same as the deep structure analysis under Section 707(a)(2): Is the payment of the purported note at the risk of the enterprise. If so, a purported "sale" to the entity for a note would instead constitute in substance either (a) disguised
equity, i.e., "preferred stock", or (b) a "security" for purposes of Section 351. If structured as a short term note in a Section 351 transaction but still at the proprietary risk of the enterprise, then presumably "security" treatment rather than "equity" treatment would apply. See Lagerquist v. Comm'r, T.C. Memo 1987-185, 53 T.C.M. 530 (1987). (Short-term notes representing another form of taxpayer's (largest minority shareholder) continuing interest in new corporation constituted "securities"). However, this deep structure policy has generally been articulated through an analysis of standards based on "arm's length" effect dealings. Thus the question often becomes whether an independent creditor would have made the loan, rather than more directly focusing on the probabilities of repayment. However, where traditional factors, particularly debt-equity ratio, are quite bad, courts often do look at the type of assets transferred and more directly at probabilities of repayment, indeed in a manner reminiscent of Otey. As discussed above, however, the Section 707(a)(2) analysis proceeds to the payment subject to entrepreneurial risk. The debt-equity analysis looks at the essential operating assets factor as well as others to determine whether payment is at proprietary risk. Where the "essential operating assets" approach is taken, the same result should obtain under a Section 707(a)(2) analysis. However, where the debt-equity ratio is less extreme, this approach is less apt to be taken. In such circumstances reliance upon more objective factors such as debt equity ratio and to a lesser extent subsequent payment history would more likely cut towards debt treatment. Although perhaps in a partnership context equity treatment is more likely.

(B) Application of Corporate Debt-Equity Principles to S Corporations.

The legislative history to the "straight debt safe harbor" of Section 1361(c)(5) states that outside of the scope of the "straight debt safe harbor" general principles are to apply. S. Rep. No. 640, supra. Apparently Congress meant to refer to such general principles both where the instrument did not fit the straight debt safe harbor and where the instrument did, but the question was an issue other than small business corporation status under Section 1361(b)(1)(D). Nevertheless, within the S corporation context Congress did spell out certain operating rules. For purposes of pro rata allocation of the S corporation's income and loss, purported debt is to be treated as debt. Id. However, at least as to retirement of purported debt issued by a C corporation that converted to S corporation status, if the purported debt in fact constitutes equity under general principles, then upon retirement Section 302(b) would be the applicable provision rather than the normal rules as to retirement of debt. Nevertheless, Congress did not examine the manner, if any, in which such general principles should be applied differently in an S corporation.

The line of cases culminating in Portage Plastics Co. v. United States, 486 F.2d 632 (9th Cir. 1973) (en banc), is instructive here. There the Ninth Circuit concluded "that the traditional thin capitalization doctrine tests for determining whether a purported loan should be treated as an equity contribution in order to prevent improper tax avoidance in other contexts are not suitable for determining whether purported loan constitutes a second class of stock within the meaning of ... [the predecessor to Section 1361(b)(1)(B)]." 486 F.2d at 636-37. The more complete reasoning was that the thin capitalization doctrine was directed towards preventing unintended tax benefits.
In the normal corporate context, indebtedness instead of equity may be used to avoid corporate level taxation on earnings paid out as interest since interest payments are deductible. Int. Rev. Code of 1954, § 163(a). It may be utilized so that a corporate distribution appears as a non-taxable or capital gain (if an excessive basis) repayment of principal where it would otherwise constitute a non-qualifying stock redemption giving rise to ordinary income. Int. Rev. Code of 1954, §§ 301(c), 302(d), 1232 [now 1371]. Ostensible debt may be used so that in the event of adversity an ordinary loss bad debt deduction under Int. Rev. Code of 1954, § 166 is available. Debt may be used to hedge against imposition of the accumulated earnings surtax. Int. Rev. Code of 1954 § 531. Finally, a corporation may issue short-term debt obligations instead of stock in exchange for depreciable property in order to circumvent the non-recognition provisions of Int. Rev. Code of 1954, § 351 and thus acquire a stepped-up basis for the property. Int. Rev. Code of 1954, § 361. Portage Plastics Co. v. United States, 470 F.2d 308, 316, 317 (7th Cir. 1972) (dissenting opinion) (author of dissenting opinion wrote en banc opinion reversing Ninth Circuit panel). See 486 F.2d at 636.

The dissenting opinion, which later became the majority en banc approach, pointed out that these traditional advantages of internal debt financing were largely removed in the S corporation context due to its pass-thru character. "Of the possible tax avoidance prospects which the thin capitalization doctrine is designed to foreclose in the ordinary corporation, only the benefit to be derived through the exchange of debt instruments for depreciable property and the benefit to be gained through distribution of pre-election, accumulated earnings and profits in the form of repayment of principal remain as possibilities in a Subchapter S format." 470 F.2d at 318, and in particular authorities cited at note 7.

In contrast, the purpose of the single class of stock requirement "was none other than to avoid the administrative complexity in the allocation of income which would result with more than one class of stock when preferred dividends were paid in excess of current earnings from undistributed taxed prior earnings. 486 F.2d at 637. This undoubtedly is the source of the statement in the legislative history to the 1982 Subchapter S overhaul that for purposes of allocation of income and loss purported debt is to be treated as debt in order to avoid just such administrative complexities. The Ninth Circuit opinion lays out this problem in more detail at 486 F.2d 637. The en banc opinion emphasized that preclusion of use of traditional debt equity concepts for determination of whether purported notes violate the second class of stock requirement "in no way forecloses use of the thin capitalization doctrine test to recharacterize purported debt as equity where appropriate to deny particular tax benefits wrongfully taken and those cases where tax avoidance through the use of debt is still available in the Subchapter S context and in those cases where it is peculiarly available within the confines of Subchapter S. 486 F.2d at 637 n.3; 470 F.2d at 318 and n.9.
In the realm of possible tax avoidance, for example, debt may be utilized for income splitting among a family group, for avoiding the vulnerability of previously taxed but undistributed income to forfeiture of its tax free withdrawal status..., or for gaining additional net operating loss deductions when the basis of stock has been exhausted by previous loss deductions. ... Portage Plastics Co. v. United States, 470 F.2d at 318 n.9. Note that the additional basis technique is probably superceded by the ability to offset losses against debt under the current regime.

In short in precisely the areas in which subchapter S debt can still make a difference: (a) bailing out pre-subchapter S accumulated earnings without dipping into C E&P where AAA is exhausted and (b) post conversion to C status bailout, that the Ninth Circuit warned traditional debt-equity principles can be applied. Estate planning might not come under this reasoning. Treatment as equity would not make a difference to the shareholder objectives—preferred stock is the tool of choice anyway.

(C) Shareholder Guaranteed S Corporation Debt

The Eleventh Circuit in Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), applied traditional debt-equity analysis to third party bank loans made to an S corporation and guaranteed by the shareholder. Selfe not only looked to traditional authorities such as Plantation Patterns, but also relied upon the analogy of the Section 385 withdrawn regulations, even though they specifically were inapplicable to S corporations (although this factor was not especially noted by the court). The Eleventh Circuit remanded for a determination of whether or not the bank primarily looked to the shareholder for repayment and for the Court to apply the factors set out in a recent Eleventh Circuit case (In re Lane, 742 F.2d 1311 (11th Cir. 1984)), which applied a traditional nine factor debt-equity analysis, and Section 385 "to determine if the taxpayer's guarantee amounted to either an equity investment in or shareholder loan to ... [the corporation]. In short, we remand for the district court to apply Plantation Patterns and determine if the bank loan to ... [the corporation] was in reality a loan to the taxpayer [shareholder]. 778 F.2d at 775. The Eleventh Circuit made no indication that these traditional rules were to be applied in any special manner due to the S corporation status.

Nevertheless, due to the approach of cases such as Portage Plastics in applying the Section 1371 mandate to incorporate C rules, including therefore Section 385, practitioners will be forced to examine more closely the particular purpose for the loans and the particular purpose of corresponding S corporation provisions. Thus the last chapter is yet to be written.

3. Conclusion

Both Subchapters K and S should contain a rationalized entrepreneur-entity transactions provision encompassing rendition of services, loans, and sales of property by the entrepreneur to the entity. The core features should be as follows:
a. Where the transaction (rendition of service, advance of money, or transfer of property) is made by the owner in a entrepreneur capacity (e.g., essential services, capital or operating assets) and (b) the entity's payment for it is subject to entrepreneurial risk as to fact or amount, the transaction and payment should be treated on a passthrough basis (non-recognition carryover basis contribution plus distributive or pro rata share of income-cum-distribution).

b. Where the transaction is not made in an entrepreneur capacity and payment is not subject to entrepreneurial risk, the contribution and payment is taxed to owner as an outsider.

c. Where the transaction is not entrepreneurial but the payment is, the payment portion should be treated as an entrepreneurial contribution of money to the entity and a distribution upon payment.

d. Where the transaction is in an entrepreneurial capacity, but payment is not, the existing Subchapter K pattern treats the payment as a non-partner transaction. This is consistent with a deep structure corporate debt-equity policy permeating the ill-fated Section 385 regulations: an owner can deal with his/her entity as an outsider if arm's length standards are met, i.e., little risk as to payment. Such a provision would be infinitely preferable to the current law's ipenetrable, but quite prickly thicket. Moreover, statutory pre-emption of the case law is desperately needed here. The case for debt-equity Congress has almost recognized, Cf. § 385 (ultimately inapplicable by regulation or statute to passthrough entities). And the treatment of services and property transfers is fairly clear on the Subchapter K statutory (and legislative history side) except as to debt-equity aspects and perhaps compensatory profits interests, which the case law has unfortunately confused with implicit, but unrecognized entity analysis.

E. Contributions

1. Introduction

The 1954 Code drafters of Subchapter K in describing the general rule of non-recognition of gain or loss upon a contribution of property under Section 721(a) merely stated that contributions to a partnership were to have the same effect under the 1954 Code as under the prior Code, in effect, permitting the tax-free transfer of property into (or under Section 731 out of) a partnership. H.R. Rep. No. 1337, supra at 68-69. The drafters of the ALI proposals forming the basis for Subchapter K similarly had adhered to the 1939 Code rule of non-recognition upon formation because they felt that to tax the transaction would tend to discourage the formation of partnerships and operate as a deterrent to new business enterprises. Moreover, if gain on such a transaction were to be taxed, there would then arise the question of whether losses on similar transactions should be allowed. Consequently, it was determined out the outset that no gain or loss would be recognized on the formation of a partnership. Jackson, Johnson, Surrey & Warren, supra 9 Tax L. Rev. at 120.
Analysis on this level alone could possibly be overridden by a deeper structure analysis that the pooling of interest in a new entity constitutes such an economic change that recognition is appropriate. Postlewaite, Dutton & Magette, A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Geot. L. J. 423, 469-70 (1987); Keyser, A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation, 5 American J. of Tax Policy 269 (1986). However, an aggregate deep structure analysis coupled with the mandatory post-1984 Section 704(c) special allocations as to built-in gain and built-in loss plus the new Section 724 five-year outside-to-inside carryover character rule support, even mandate, non-recognition under Section 721 since through them a contributing partner in effect stands in virtually the same shoes as he/she stood as an individual entrepreneur.

Subchapter S in this context incorporates Subchapter C under Section 1371. Subchapter C in turn rests in the context of tax-free incorporation solely on the purpose of facilitating business readjustments. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, pp.3-3-3-4 (4th ed. 1979). In the context of Subchapter S there is no parallel aggregate approach ability since special allocations are not possible.

Unlike Section 351, Subchapter K's Section 721 does not require that the contributors be in "control" of the partnership. But, like Section 351, it applies to formation and subsequent contributions. Treas. Reg. § 1.721-1(a).

Conventional wisdom holds that "property" means the same for Sections 351 and 721. Stafford v. United States, supra; P.L.R. 8117210. But, in fact, different deep structure policies apply due to Subchapter K's aggregate core and Subchapter S and C's separate entity core as discussed above at p. __.

Both Subchapter K and the incorporated Subchapter C provide as a concomitant to non-recognition under Sections 351 or 721 carryover basis as to the transfer of property in the transferee entity's hands, I.R.C. §§ 388(b) and 723 and as to the transferor owner, substituted basis in the received equity interest, I.R.C. §§ 358 and 722.


a. Introduction


Conventional 1954 Code wisdom held that generally nonrecognition and carryover-substituted basis was the preferred tax goal in transfers of property to a controlled entity. Recognition and step-up in basis, on the other hand, were thought generally desired only where the transferor (a) had expiring deductions or credits (such as capital loss carryover or net operating loss deduction), e.g., Ellis, Tax Problems on Sales to Controlled Corporations, 21 Vanderbilt L. Rev. 196, 224 (1968), or (b) wished to "lock in" the character of the gain, e.g., Note, Capital Gains Treatment for Gain Realized in Condominium Conversions, 47 Mo. L. Rev. 269, 275 (1982). If the elimination of the capital gains income preference actually goes into effect in 1988, lock in of character largely will become a historical footnote. The other conventional reasons for recognition transactions or in the case of a
corporation issuance of securities, consisted of (c) tax-free withdrawal of investment and (d) single tax on investment return through deductible interest. Neither of these latter two goals makes much sense in an S corporation or a partnership context. (An S to C conversion, now unlikely in itself, may constitute an exception.)

ii. The Other End of the Telescope: Withdrawal of Contribution.

A major factor generating divergent development as to sale/contribution to passthrough entities arises from the disparate treatment at the end of the investment transaction, i.e., withdrawal or distribution of the taxpayer's investment. For it is much easier to use the partnership mechanism for a liquidating or non-liquidating distribution tax-free at both the partnership level and the partner (level up to basis). Thus upon initial formation of a partnership under pre-1984 rules a partner could contribute an appreciated essential operating asset to the partnership tax-free under Section 721 and the partnership then distribute cash from another partner or from a (recourse) loan as to the assets tax-free under Section 731 to the property-contributing partner. See Otey v. Comm'r, 70 T.C. 312, 320-21 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980).

In contrast the Subchapter S withdrawal rules work simply only where (a) no C E&P is present, and (b) cash is used. See I.R.C. § 1368(b). Moreover, the basis limitation upon owner level tax-free withdrawals is much more stringent in the S corporation context since inside borrowings do not increase the shareholder's outside basis, unlike in the partnership context. Compare I.R.C. § 1367(a)(1) with §§ 752(a) and 722. If C E&P is present, usually from a C to S conversion, then the accumulated adjustment account rules kick in to complicate matters. I.R.C. § 1368(c); Coven, supra 42 Tax L. Rev. at 56-59. In an S corporation context a contributing shareholder cannot avoid these problems by borrowing on appreciated property and then contributing it to the S corporation since post-acquisition liabilities are not included in basis. Lee & Bader, Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income, 12 J. Corp. L. at 221-22 n.508 (1987). Hence such borrowing automatically would create liabilities in excess of basis for purposes of Section 357(c). Thus, a borrowing followed by contribution would trigger at least Section 357(c) and more likely the tainted liability rule of Section 357(b). In-kind non-liquidating and liquidating distributions by an S corporation trigger inside gain, I.R.C. § 1363(d) and (e), (which is then allocated to all the partners according to their "pro rata" share, I.R.C. § 1377(a)). Furthermore, if such an in-kind distribution is cast as a redemption, the redeemed shareholder may find it difficult to qualify for outside capital gain. Section 355 may not be used by contributing shareholders as a means of exchanging tax-free properties which contribute to a corporation and then spin off on a cost basis.

b. Subchapter K.

The 1954 House version of Subchapter K would have provided a parity of treatment as to "contributed" property and "sold" property as to transfers by a "controlling" (50%) partner. In order "to prevent the sale of property between a partnership and a 'controlling' partner for the purpose of recognizing losses or raising the basis of property", H.R. Rep. No. 1337, supra at 67, the House bill provided that a sale between the partnership and the
controlling partner would not be recognized and carryover basis would be mandatory. *Id.* at 67-68.

ABA witnesses at the Senate Finance Hearings on the 1954 Code criticized this rule as "too rigid for practicality." *Hearings on H.R. 8300 (the 1954 Code) Before the Senate Finance Committee, 83d Cong., 2d Sess. (Part 1) 466 (1954) ("1954 Code Hearings"). This rule coupled with the House rule precluding special allocation of built-in gain or loss meant as a practical matter that it would be impossible for partners to adjust the potential inequities of contributing low-basis property to the partnership. *Id.* at 467.

The Senate Finance Bill looked to the perceived source of the problem—prevention of tax avoidance through the realization of fictitious losses or increasing the basis of property for purpose of depreciation—and instead applied general rules parallel to Sections 267 and 1239 disallowing built-in losses and recharacterizing gain where (higher level of ownership) "controlling" partners sold property to the partnership. See *S. Rep. No. 1620, supra* at 387.

The end result under the 1954 and hence 1986 Codes is that a sale of appreciated (nondepreciable) property to a partnership is recognized or not (and hence treated as a contribution plus distribution) essentially under case law doctrine. Generally speaking a transaction cast as a sale is treated as a contribution only where the partnership's purchase is through a note which then may be considered equity as discussed above.

Perhaps more common, and certainly receiving more attention recently, has been the reverse transaction: a transfer cast as a contribution of property followed by a distribution of property of money by the partnership to the contributing partner. The issue here is whether the contribution/distribution is recognized or is treated as in substance a sale by the transferring partner to the partnership.

Prior to the 1984 enactment of Section 707(a)(2) the three major methods for capitalizing a partnership with a transfer of property (generally appreciated in the hands of the transferor "partner") for use in its business were: (1) a sale by the transferor in a Section 707(a) (now Section 707(a)(1)) non-partner capacity; (2) a tax-free contribution under Section 721 and capital account equalization by tax-free (to the extent not in excess of the transferor partner's basis in his/her partnership interest) Section 731 distributions [Query, is Section 751(b) inapplicable to initial transfer?]; and (3) a sale of an undivided interest in the property to the other partners followed by a joint tax-free Section 721 contribution of the property to the partnership. *Barenholz v. Comm'r,* 77 T.C. 85 (1981). Economically all three transfers are equivalent but radically different tax consequences attached.

Full recognition of gain (or loss in some cases) by the transferor partner results from a Section 707(a)(1) non-partner capacity sale. Sale of an undivided interest and joint tax-free conveyance possibly results in partial recognition and partial contribution at the partner level as well as partial carryover and partial cost basis at the partnership level. If the form of a Section 721 contribution followed by a Section 731 distribution is respected, no gain or loss is recognized upon either of these events, but through basis reductions in the transferor partner's interest in his partnership under Section 733 the gain is deferred by him or her until the interest is sold or liquidated.
The Section 721 regulations have long provided that Section 721 does not apply to a Section 707 transaction between a partnership and a partner not acting in his capacity as a partner.

Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See § (c)(3) of § 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other considerations, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. Treas. Reg. § 1.721-1(a).

The "substance over form" transaction described in the cross-referenced Section 731 regulations appears on the surface identical to the Section 721 contribution/Section 731 distribution described above. For the regulation states that if (a) there is a contribution of property to a partnership; (b) "within a short period" before or after such contribution other property, implicitly including money, is distributed to the contributing partner; and (c) the contributed property is retained by the partnership, Section 731 does not apply to the distribution, but instead the transaction is treated as an exchange of property between the partner and the partnership. Treas. Reg. § 1.731-1(c)(3) (this provision also characterizes contributions by two partners followed by cross distributions as exchanges of property between the partners outside the partnership). Many assumed from the above regulations that all three methods of capitalization would at least in part be treated as sales. However, the Tax Court in Otey v. Comm'r, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (1980), applied a Section 707(a) analysis to determine if in substance (a) the transfer of appreciated property by one partner to a partnership for development, with the other partner providing services in obtaining financing for the partnership through his good credit, followed by (b) a distribution of the loan proceeds up to the fair market value of the property to the first partner, constituted (i) a Section 721 contribution of the property or (ii) a Section 707 outsider "sale" of the property to the partnership. The Tax Court in Otey applied a six factor analysis, the most important of which focused on (a) the relationship the transfer bore to the partner's capacity as a partner, i.e., whether the transferred property constitute an essential asset--"a part of the very raison d'etre of the partnership."--and (b) whether payment by the partnership was at the risk of the economic fortunes of the partnership (apparently based on analogy to Section 707(c), 70 T.C. at 318, 320-21). On a deeper structure level, the Tax Court reasoned that "[w]ere there no partnership at all, a taxpayer could borrow funds on the security of the appreciated property and apply them to his personal use for that triggering gain." 70 T.C. at 321; compare Lane, supra, 46 So. Cal. Rev. 239. The Otey court overlooked, however, that in the event of a default and full payment by the transferor partner, he/she might under local law have a claim of subrogation for half of the amount paid under such joint and several liability from the other partner. In the perhaps more likely event the partnership proved successful and paid off the bank loan through revenues, the contributing partner would in effect have shifted half
of the economic burden of the loan repayment to the other partner. Since loan principal payments are not deductible, partnership taxable income (in excess of other deductible expenses) must be used to make the principal payment. The other partner will be taxed on such income used to make the principal payment, but there will be no corresponding cash or distribution. However, this will be the case for the contributing partner as well. Hence there will be no capital account inbalance and no obligation of the contributing partner to pay out the other partner's positive capital account arising through partnership income used to pay nondeductible loan principal payments. Thus, the other partner has borne half of the economic burden of the loan.

The Tax Court in Otey appears to have relied more heavily on the factor of whether the taxpayer got to keep the distribution, i.e., was at the risk of the economic fortunes of the partnership (i.e., if the partnership failed to pay the obligation, the contributing partner would be called upon to repay it), than on the fact that the transferred property was the only contributed capital and necessary to fulfillment of the purpose of forming the partnership (i.e., development of the appreciated property for rental purposes).

A number of decisions considered the issue of Section 721 contribution (plus Section 731 distribution) versus Section 707 sale within several years after Otey. Some decisions also focused on whether the contribution/sale was of an essential operating asset. Park Realty Co. v. Comm'r, 77 T.C. 412 (1981). Where new partners contributed cash for admission to a partnership accompanied by pro rata distributions of cash to the old partners, the Claims Court in particular declined to find a Section 707 sale. See Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980). Indeed, the Claims Court held in this context that such contribution/distribution of cash did not constitute a sale of a portion of the old general partners' interest to new (limited) partners because the outside rights and obligations of the new partners varied from the outside rights and obligations of the old partners as to preferential distributions, management functions and the general difference between a general partnership and a limited partnership interest. Jupiter Corp. v. United States, 2 Cl. Ct. 58 (Cl. Ct. 1983).

The Tax Court in Park Realty similarly placed emphasis on (inside) form over substance where a partner contributed substantially improved property to a partnership pursuant to a partnership agreement requiring payment to the contributing partner of its "development" cost in the property which the court found did not represent assets transferable and valuable independently or apart from the unimproved real property. The partnership agreement contemplated that the reimbursement of such cost would be paid to the contributing partner upon sale by the partnership of key portions of the conveyed property. The Tax Court in Park Realty faced with these facts (the Government and taxpayer stipulated that the development cost did not constitute assets transferable or valuable apart from the land or the development) refused to accept the IRS's recharacterization of the distribution for reimbursement of the development cost as constituting a sale or exchange of the rights to those costs.

Surveying in 1984 several of the above cases, including Otey and Jupiter Corp., the Senate Finance Committee concluded that "court decisions have allowed tax-free treatment [Section 721 contribution followed by Section 731
distribution] in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance." S. Rep. No. 169, supra.

Section 707(a)(2)'s legislative history dictating the direction of the regulations indicates greater promise than the mere technical amendment perceived by most commentators. The role of Section 707(a) has always been to distinguish between partner and non-partner transactions. The drafters of the 1954 Code believed that the former merit "aggregate" treatment, i.e., tax-free contribution and distribution up to basis; the latter, entity treatment, i.e., sale/exchange treatment as with an outsider. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 67, A226 (1954); S. Rep. No. 1622, supra at 386; H.R. Rep. No. 2543, supra at 59. The case law adequately developed the partner-capacity test as to the transfer of property/performance of services: essentially, whether (a) such services constitute a part of the activity the partnership is engaged in, Pratt, 550 F.2d at 1028, or (b) the property transferred is an essential asset, "part of the very raison d'etre of the partnership," Otey v. Comm'r, 70 T.C. at 320. While the case law also purported to focus on "whether payment by the partnership to the partner is at the economic fortunes of the partnership," Otey, supra, here the legislative history to Section 707(a)(2) appears destined to play the major role. For this history elucidates that the fact and amount of payment for partnership capacity transfers or rendition of services must be subject to entrepreneurial risk. But if, in a partner-capacity transaction, the purported partner performs services or transfers property and is paid an allocation-cum-distribution in a partner-capacity manner, i.e., subject to entrepreneurial risk, then legislative history to Section 707(a)(2) indicates that once a service performer or property transferor is determined to be "actually a partner," S. Rep. No. 169, supra at 227, presumably under the above case-law criteria, then a second step entrepreneurial risk analysis must be applied to determine whether the partner is receiving the putative allocation and distribution in his capacity as a partner. Furthermore, Congress dictated that "regulations will provide persons who [formally] become partners after performing services for, or transferring property to, the partnership are to be treated as partners [at the time of the provision of services or transfer of property." S. Rep. No. 169, supra at 232 (bracketed language added in 1986 Bluebook, supra 233).

Congress very subtly shifted the focus of these new Section 707(a)(2) to the underlying economic substance. Thus, in the case of "proper characterization" of payments for services or property under Section 707(a)(2)(A), the test is whether the allocations and distributions "which are determined to be related" to the performance of services/transfer of property and "which, when viewed together with distributions, have the substantive economic effect of direct payments for such property or such services..." S. Rep. No. 169, supra 226.

The test for whether a transfer of money other property by a partner to a partnership when viewed in connection with a related direct or indirect transfer of money or other property to that partner or another partner is "properly characterized" as a "disguised sale" of property under Section 707(a)(2)(B) is whether "the transaction substantially resembles a sale or exchange of all or a part of the property..." in the case of a partial sale and partial contribution. Id. at 230-31.
For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of the contributed property that is in effect given up to the other partner(s) the transaction will be subject to this provision [Section 707(a)(2)(B)].

This Committee Report authorizes regulations providing for a period, such as three years, during which contributions by and distributions to the same or another partner normally would be presumed related. Id. at 231. Compare ALL, supra at 185 (24-month period).

You will recall that Otey turned on a number of factors, the most important of which, it is true, was the Tax Court's view that the risk of the loan repayment remained with the transferor partner, but also the fact that the contribution went to the essence of the partnership operations and was the sole capital constituted a significant factor. The legislative history subtly retains the Otey partnership capacity as to the character of the transaction factor. For in the case of both characterization of payments for services or property and disguised sales, the legislative history indicates that the first determination is whether the service performer or property transferor is actually a partner. S. Rep. No. 169, supra at 227, 230. Presumably, the Otey analysis of whether the contribution or provision of services went to the heart of the partnership would still be relevant on this question. But, in the case of 707(a)(2)(A) the determinative question is whether the partner is "receiving the putative allocation and distribution in his capacity as a partner." Id. at 227 (emphasis supplied). Conversely, where a partner receives an allocation (or an increased allocation) for an extended period reflecting his contribution of property or services, Section 707(a)(2)(A) does not apply if "the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner." Id. at 226.

The most important factor as to whether the allocation and distribution is received in a partner capacity under Section 707(a)(1)(A) is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture while third parties generally receive payments which are not subject to this risk. An allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution [under Section 731], while an allocation and distribution provided for a service partner under the partnership agreement which involves limited risk as to amount and payment should generally be treated as a fee under sec. 707(a). For example, allocations that limit a partner's risk may be either "capped" allocations of partnership income (i.e., percentage or fixed dollar amount allocations subject to an annual maximum amount when the
parties could reasonably expect the cap to apply in most years) or allocations for a fixed number of years under which the income that would go to the partner is reasonably certain. Similarly, continuing arrangements in which purported allocations and distributions (under a formula or otherwise) are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services also shield the purported partner from entrepreneurial risk. S. Rep. No. 169, supra at 227; Compare Leder, supra 41 N.Y.U. Inst on Fed. Tax. at 14-8, 14-9, 14-16-17, 14-32 (model for Section 707(a)(2)(A) and Committee Report discussion).

The legislative history's analysis of partner capacity transfer coupled with non-partner capacity payment is not as detailed in the context of a disguised sale under Section 707(a)(2)(B) but the same analysis should apply. A transfer of an essential operating asset would, indeed, constitute a partner capacity transfer (under Otey) and hence is not subject to Section 707(a)(1). On the other hand if the payment economically resembles a sale or exchange because a distribution of money or property occurs within a reasonable period after the contribution, then deemed Section 707(a)(1) treatment applies.

c. Subchapter S.

Recently the Senate Finance Committee Staff has proposed that wherever a 20% or more shareholder transfers appreciated property to his/her moderately "controlled" corporation, mandatory carryover basis and non-recognition is to apply. However this is not yet the law. Therefore a "sale" of property to an S corporation by a shareholder is recognized as a sale unless under debt-equity analysis the S corporation pays with a note that is treated as equity. This is discussed above.

Due to the different workings of Subchapters S and K, S shareholders are less likely to cast a transaction as a tax-free contribution followed by a tax-free distribution.

Section 351, including Section 351(b), applies to S corporations through Section 1371. Under Section 351(b) recognition property or "boot", i.e., not non-recognition property or stock or securities, is taxed notwithstanding Section 351(a) to the shareholder to the extent of gain recognized on the transaction. This in effect means that the transferring shareholder does not get to use any basis until the boot exceeds the gain on the property transferred. The 351(b) determinations are made property by property.

Under the temporary installment reporting regulations, a shareholder installment sale for a boot note, does allow installment reporting at the shareholder level, but the transferee corporation "properly" obtains basis under Section 1362 only as the shareholder reports income under Section 453.

These patterns contrast strongly with the partnership patterns.
d. **Conclusion**

For both Subchapter K and Subchapter S the true issue is whether there should be mandatory carryover for ease of administration or whether essential operating assets plus risky payment analysis like Section 707 should apply.

3. **Boot: Part- Contribution/Part-Sale**

a. **Subchapter K**

In 1984 Congress directed that regulations under Section 707(a)(2) treat appropriate transactions as a partial sale and partial contribution of property to the partnership. This directive does not address allocation of basis. Commentators differ as to the amount of basis that the transferor may allocate to the "sale" portion of a partial sale and a partial contribution. See Rubinstein, Transfers of Property to a Partnership: Contributions or Sales and Related Uncertainties, 34 Tax Law. 371 (1980).

b. **Subchapter S**

In contrast, Section 351(b) on its face allocates no portion of basis to the boot or sale portion of the transaction. However, "boot" is limited to total gain, hence the entire basis in appropriate circumstances is taken into effect.

4. **Liabilities in Excess of Basis**

a. **Subchapter K**

General partnership rules governing transfers of encumbered property to a partnership are contained in Treasury Regulations §§ 1.722-1 and 1.752-1(b)(2); see Treas. Reg. § 1.721-1(a)(last two sentences). These regulations apply a mixed aggregate-entity approach: to the extent of the transferor partner's Section 752 "share" of the transferred liabilities after the transfer of the encumbered property to the partnership, his/her exchange of the encumbered property for the partnership interest is treated as a "mere change in form" producing non-recognition under Section 721 and no "constructive cash distribution" under Section 752. However, to the extent that the other partner[s] share after the exchange is reduced in the "transferred" liability under Section 752, that portion of the exchange in effect is treated under an entity approach. For that portion of the liability now "shared" by the other partners is treated as a constructive cash distribution. And under the general rules to the extent that such distribution exceeds the transferor partner's basis, gain is recognized under Section 731.

In many, if not most cases, excess encumbered property transferred to a partnership also has an excess of fair market value over basis, unless fair market value has declined as fast as depreciation deductions or other transactions reducing basis below the amount of the liabilities. To the extent that the partner transfers the property with a built-in gain, the combination of Sections 724 and 704(c) will ensure that such gain will be allocated to the transferor and for five years after the transfer will retain the same character as it would have had in his/her hands. Similarly, a sale of the transferor
partner's partnership interest within five years will trigger essentially the same character/allocated gain under Section 751. Thus, the transferor partner would under the general partnership rules would be taxed ultimately on the Crane gain and hence a tax at transfer is inappropriate.

The above analysis ignores the potential partnership pay down of the transferred liability. The partnership can however allocate, in a manner like the principles of the non-recourse debt allocation of liability portions of the Section 704(b) regulations, gross income to the transferor partner as soon as possible whenever the transferred debt principal amount is reduced—i.e., a minimum gain charge back. Cf. Treas. Reg. § 1.704- If the partnership agreement contained such a provision, then in effect the transferor partner still in effect retains an interest as to the transferred property and debt. Accordingly, the liability in excess of basis rule should not apply upon the transfer to the partnership where such a charge back is provided.

As discussed below, Section 357(c) contains exceptions to the corporate liability in excess of basis upon transfer rule for "trade accounts payable" and similar obligations and provides for recognition as to "tainted" liabilities, i.e., transferred liabilities for which no business purpose for the transfer or occurrence of the liability is present. Section 752 and the current regulations contain no comparable provisions. However, Congress, with a "thumb" on the scales, has directed revisions of the Section 752 regulations to contain comparable trade account payables exceptions. Furthermore, in the 1984 amendments to Section 707 to cover "disguised sales", i.e., Section 707(a)(2)(B), Congress described the disguised sale provision as also applying to the extent that "the partner has received the loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners." This rule parallels Section 357(b) except that the latter taints all liabilities, whereas the partnership rule does not.

Piecing together the way Congress intended the new Section 707(a)(2)(b) rules to be promulgated in future regulations governing transfers of encumbered property to a partnership is difficult due to the overly laconic and unfortunately opaque at best and more likely contradictory statements in the legislative history. First, the Senate Finance Committee Report stated that Congress did "not intend to change the general rules governing the tax treatment of the partners under Sections 721, 731, and 752 to the extent (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than anticipation of the contribution resulted in a deemed distribution under sec. 752(b)." S. Rep. No. 169, supra at 230. Essentially, the above cited rules work together to treat the portion of a liability assumed or taken subject to by the partnership upon a contribution of property by a partner which is "shared" by the other partners under Section 1.752-1(e) of the regulations as a constructive cash distribution. See Treas. Reg. §§ 1.752-1(b)(2) and 1.752-1(c). Such a constructive cash distribution is treated as if it were a real distribution of money under Section 731 (and in some circumstances can trigger a Section 751(b) disproportionate distribution, but probably not upon an initial contribution). See generally, Parker & Lee, Constructive Cash Distributions In A Partnership: How and When They Occur, 41 J. Tax. 88 (1974). Under these provisions the distributee partner can use his/her entire outside basis in
his/her partnership interest to offset the constructive cash distribution with only the excess over such basis being treated as a constructive sale or exchange.

The above cited discussion specifically excluded liabilities incurred in anticipation of the contribution. The Committee Report treated an anticipatory loan the same as a "distribution" of the proceeds of a loan taken out by the partnership with respect to the contributed property and distributed to the contributing partner. S. Rep. No. 169, supra at 231. As discussed above, such distribution of loan proceeds is treated as a disguised sale under Section 707(a)(2)(B) if the "responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners." S. Rep. No. 169, supra at 231. The surface import of this language is that transfer of responsibility for repayment or initial responsibility for repayment lying in the partnership (or its assets) would treat the entire amount of the loan proceeds as a disguised sale. However, two factors militate against this. The formulation in the legislative history of the "responsibility for repayment" is substantially similar to the ALI Proposal, supra at 184 which the reporter stated would result in Otey "being treated as a sale of a 50 percent interest in the real estate and a contribution to the partnership of the joint owners of the real estate. Where the original owner of the property remains solely liable for the debt, however, the sale would be treated as occurring [sic]." ALI, supra at 186. The cryptic Conference Report reference that no disguised sale is to result to the extent the contributing partner, in substance, retains liability for repayment of borrowed amounts, i.e., to the extent the other partners have no direct or indirect risk of loss as to such amounts, would indicate that to the extent that the contributing partner shares the partnership liability the proceeds of which were distributed, the distribution is treated as a Section 731 distribution and not as a Section 707 sale. Therefore, at this point we have nonanticipatory loans being treated as a constructive cash distribution to the extent the other partners share in the transferred liability or liability to which the transferred property is subject. Conversely, anticipatory transfers are treated to the extent the other partners share in the liability as a "disguised sale" under the Section 707(a)(2). In most cases the character of the amount realized would be the same (although there are exceptions). The question of whether basis must be allocated between the disguised sale portion and the contribution portion is discussed below.

Unfortunately, however, the Committee Reports continue that "the contribution of encumbered property to a partnership would not suggest a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partner." S. Rep. No. 169, supra at 231. The clear import of this language is that to the extent that the encumbrance is so shifted, a disguised sale will result. This conflicts with the first statement that the existing general rules regarding contributions of encumbered property are continued to apply and renders somewhat superfluous the "anticipatory" loan rule discussed above.

Furthermore, treating a contribution of encumbered property as in part a disguised sale to the extent of shifting of responsibility or debt repayment, clearly leaves the implication that the remainder of the transfer will be treated as a Section 721 contribution. Indeed in more than one place, and in particular directly following the contribution of encumbered property
discussion, the legislative history "anticipates that the Treasury Regulations will treat transactions to which the provision applies as a sale of property or partnership interest among the partners or is a partial sale and partial contribution of the property to the partnership, with attendant tax consequences, depending upon the underlying economic substance of the transaction." S. Rep. No. 169, supra at 231.

The reference to a partial sale and partial contribution opens the door for the issue of whether the contributing partner must make a proportionate allocation of the basis of the transferred assets between the sale portion and the partial contribution portion. Prior to Section 707(a)(2) one commentator had argued that a transfer to a partnership for an equity interest and a "true sale" (rather than a constructive cash distribution from contributive property with liabilities in excessive basis) should require a proportionate allocation of the basis of the transfer property to the sale portion and to the contribution portion. Rubinstein, Transfers of Property to a Partnership: Contributions or Sales and Related Uncertainties, 34 Tax Law. 371, 390 (1980). The commentator acknowledged that transfers of encumbered property were not treated in this manner. Leading treatise writers in reliance upon the excess liability contribution rules argue to the contrary that a true part sale part contribution should be taxable only to the extent that the sale portion amount realized exceeds the entire basis. McKee, Nelson & Whitmire, supra at Supp. ¶ 4.0115. It should be noted that the general Crane doctrine allows the transferor of property to offset against the Crane phantom gain the entire basis. Surely the drafters of the legislative history could have made it a little more clear. McKee, Nelson & Whitmire, supra at Supp. S4-6.

Conceivably the Section 707(a)(2) regulations could distinguish between (a) a contribution of encumbered property and (b) a partial sale (with non-liability "discharge" boot) and a partial contribution. No sound policy reason suggests itself at first blush. Presumably the reference to partial sale and partial contribution was made specifically to bring up this issue. Furthermore, McKee's argument, based upon 731(a) as permitting offsetting the entire basis in the transferred property against the "sale" portion, falls down when the distribution, even a constructive cash distribution from liability "decrease", is treated as a sale. Therefore we may expect a required allocation of basis between the sale and contribution portion, thereby increasing the gain on the sale or boot portion and leaving some basis in the contribution, along with a carryover basis inside. Furthermore significant inside basis adjustments could result according to whether distribution or partial sale partial contribution reasoning applies. The constructive cash distribution Section 731 approach gives rise to an inside basis adjustment only if the transferee is taxed on a cash distribution in excess of basis and a Section 754 election is in effect so that Section 743 applies. Furthermore, this inside "increase" generally must be allocated under Section 755 solely to capital assets and Section 1231 assets. In contrast, in a partial sale, the partnership would have a cost basis in the deemed purchased portion of the property transferred and such cost would be allocated to the particular assets deemed purchased rather than according to the type of gain recognized by the contributing-selling partner.
b. Subchapter S.

The S corporation rules themselves contain no special provisions as to transfers of property, including encumbered property, to an S corporation. Rather Section 1371 must be looked to, which incorporates general C corporation rules to the extent not inconsistent with Subchapter S. Section 357(a) provides that liabilities with respect to property "transferred" recourse or non-recourse to a corporation in a Section 351 transaction generally are not treated for recognition purposes as boot. (For basis purposes, they are treated under Section 358(d) as "boot" or cash, thereby reducing the shareholder's basis in the stock received for the transferred property.) Section 357(b) carves out a seemingly a significant exception where any liability transferred is "tainted", i.e., no business purpose for the transfer or the occurrence of the particular, tainted liability, in which case all transferred liabilities are recognized. Where Section 357(b) does not apply, but liabilities exceed basis, Section 357(c) treats such excess as gain arising from a sale or exchange of the transferred property. Section 357(c)(3) carves an exception for trade accounts payable and similar liabilities which are not counted in the formula of liabilities over basis.

The net effect of these rules under conventional wisdom is that the entire amount of the transferred liability in excess of basis (where no exceptions apply) is taxed to the transferor shareholder. However, just as in a partnership, the Crane gain but for this rule would be ultimately recognized by the S corporation if it sold the property. A portion of this gain would pass through to the transferor shareholder. Therefore, again on a policy basis there is no need to tax the transferor shareholder as to the "retained" portion of the built-in gain/loss. Thus the S rules on a policy basis should parallel the classic understanding of the partnership liability rules (prior to the Sections 724, 707(c) changes). One could argue that the full recognition of the entire amount of the excess liability provided by Section 357(c) is to the extent of the transferor shareholder's "pro rata" interest in the S corporation stock inconsistent. Thus, one could argue that only the portion of the liability corresponding to the other shareholders' interest in the S corporation should be triggered under Section 357(c). Later allocation of the "inside" gain to the transferor alone would be hard, however.

In conclusion, under conventional doctrine the S corporation rules produce a greater gain than the partnership rules. Even under the above policy-based proposals the partnership rules would yield less gain than the S corporation rules.

Here too the focus historically has been on form rather than on probability of the transferor shareholder being called upon to repay the loan. An exception is the Jackson case in the Ninth Circuit which looked to this factor. However, Jackson is contrary to the overall approach to the Crane doctrine here which does not particularly look at probabilities, but looks either at "reversed assumptions" or at true debt analysis, neither of which take into account particularly probabilities of repayment. Here again, a substantial difference exists between partnerships and S corporations, which probably should not.

Both the Subchapter K and the Subchapter C rules applicable to S corporations under Section 1371 rules seek to incorporate the Crane
doctrine. At the time of the enactment of the 1954 Code Crane was thought to hold that upon transfer of encumbered property, at least by sale, the taxpayer's "amount realized" (for purposes of Section 1001) included liabilities to which the property was subject (regardless of whether the purchaser assumed such liability). Thus, liabilities in excess of the seller's basis produce gain, at least up to the fair market value of the encumbered property under the then prevalent view of the meaning of the famous footnote 37 in the Crane decision, recently overruled by the Supreme Court in Commissioner v. Tufts as to the fair market value ceiling.

The Subchapter S and the Subchapter C corporation rules produce disparate results upon an otherwise tax-free contribution of excess liability property to the entity. Section 357(c) applies an entity approach so that the entire amount of the liability in excess of the transferor shareholder's basis generally constitutes gain regardless of the fair market value of the property. On the other hand the existing Subchapter K regulations employ a mixed aggregate-entity approach. The partnership rules thereby produce a lesser amount of recognized gain upon a contribution under Section 721 of encumbered property than a contribution under Sections 351 and 357(c) because under the partnership approach only the portion of a liability is "allocated" to the other partners gives rise to a constructive cash distribution where the excess of such lesser distribution constituting the recognized gain. The impact here too of Section 707(a)(2) is yet to be plumbed.

F. Distributions

1. Subchapter K

   Essentially an "aggregate approach" applies to a liquidating partnership distribution in kind. Section 736 should not apply on the theory that an in-kind distribution does not constitute a "payment." No gain is recognized by either the partnership under Section 731(b) or the partner under Section 731(a), unless in the latter case cash exceeds his/her basis in his/her partnership interest or the "disproportionate distribution" rules of Section 751(b) described below apply. Losses are recognized by a partner (excess of his/her outside basis over the sum of money and his/her basis in distributed inventory and receivables) in a liquidating distribution where only money and receivables are distributed. In that case there is no carry-over basis property to "carry" the accrued loss. The character of receivables carries over from the partnership to the partner under the aggregate-like mandate of Section 735. This provision, however, is not as detailed as the later analogue for transmission-in of character upon a contribution of property (Section 724).

The partner does not, however, use in liquidating distributions the partnership's inside basis for the distributed property as in non-liquidating distributions in kind. Rather, the partner applies his/her outside basis in his/her liquidating partnership interest (less cash distributed in the same transaction) under Section 732(b). Liabilities under this aggregate approach pose no problems. True, the partner holding the liquidating partnership interest may incur a substantial "constructive cash distribution" due to his/her ceasing to share in partnership liabilities. However, this constructive cash distribution is deemed matched simultaneously by an equal constructive cash contribution by the liquidated partner to the liquidating partnership due to his/her receiving the distribution in kind subject to the accompanying
liabilities. Again a disproportionate distribution is subject to Section 751(b). Liquidation of a partner's interest or liquidation of the partnership generally will trigger the "revaluation" capital account rules of Treasury Regulation § 1.704-1(b)(2)(iv)(f).

Note that if a partner has an obligation to restore a deficit in his/her capital account (necessary for a Section 704(b) allocation creating a deficit to stand up unless special rules apply), withdrawal from the partnership without paying the deficit may generate "cancellation of indebtedness" income (if the allocation creating the deficit stands?).

a. Distributions Subject to Return

The Senate Finance Committee Report describing Section 707(a)(2)(B) states that it applies where, "taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property. . . . For example, when a partner contributes appreciated property to a partnership and receives the distribution of money of property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of the contributed property that is effect given up to the other partner(s) the transaction will be subject to this provision." S. Rep. No. 169, supra at 230-31. "Entrepreneurial risk" applies in a Section 707(a)(2)(B) context where the distributee partner may be required to return the distribution. The Committee Report discusses two situations in which this could occur: (1) a recourse loan obligation to the extent that responsibility for repayment of the loan rests with the other partners or their share of the partnership income and, (2) a distribution that creates a deficit capital account which must be restored. S. Rep. No. 169, supra at 231.

i. Distribution of Loan Proceeds

The Tax Court in Otey purported to apply an "entrepreneurial risk" approach to loan proceeds distributions: "Where the payment by the partnership to the partner is at the risk of the partnership's economic fortunes of the partnership." 70 T.C. 320. The court found that Otey was at the risk of the economic fortunes because if the partnership cash flow was not sufficient, under his joint and several liability he could be liable for the full loan if the partnership defaulted. Id. at 320-21. But the court overlooked the consequences of the loan being repaid with partnership cash flow. The share of the other partner of the cash flow would be reduced to the extent the principal payments were made. Therefore, the ALI Proposals would reverse Otey to the extent that the responsibility for repayment of the loan was wholly or partially transferred to the partnership or the other partners. Thus, the transaction in Otey would have been treated as a sale of a 50% interest in real estate to the other partner and a contribution to the partnership of the joint owners of the real estate. Id. at 186. Apparently where the original owner remains solely liable for the debt, no sale would be treated as occurring. Id.

The Senate Finance Committee Report took the same approach. The disguised sale provisions also will apply to the extent (1) the transferor partner receives the proceeds of a loan

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related to the property to the extent responsibility for the repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the other partners, or (2) the partner has received the loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners. S. Rep. No. 169, supra at 231.

The Conference Report followed the Senate Finance Committee provision here. However, it noted that

[when] a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with the respect to the borrowed amounts, this may constitute a payment to the contributing partner. H. Rep. No. 861, supra at 882.

It is unclear whether the conference report requires that the focus solely beyond whether the other partners have any direct or indirect risk of loss, or whether the factor of responsibility for repayment resting with the partnership or its assets should be considered as well. For example, if the partnership loan were nonrecourse, then the other partners (and the contributing partners as well as a matter of fact) would not bear the risk of loss other than indirectly as the partnership loses assets that the partners would otherwise be entitled to upon liquidation.

Apparently, a partner could contribute encumbered property without triggering Section 707(a)(2)(B) by retaining total liability for the loan repayment. This calls to mind the Stonecrest doctrine under which wraparound mortgages originated. Here, however, no payments would be made by the partnership to the contributing partner, rather he/she would simply remain liable for the total loan and make the required payments to the creditor.

It also should be possible for the contributing partner to be fully responsible for the loan repayment where the loan is taken out by the partnership after the contribution and proceeds distributed to him. This can be achieved by providing a "special allocation" analogous to a "minimum gain charge back" under the nonrecourse liability portion of the Section 704(b) regulations. Cf. Treas. Reg. § 1.704-1(b)(4)(iv)(e). In other words as principal payments are made on the loan, the distributee partner will be allocated, before any other allocation is made under Section 704(b), items of income and gain for that tax year (and if necessary subsequent tax years) in an amount equal to such principal payment. Thus, the distributee partner will be taxed with partnership income equal to the prior distribution benefit. Of course
this approach, just as the Section 704(b) regulations, ignores time value of money considerations. In light of consideration given by Congress to this factor in a similar context, as discussed below, a minimum gain charge back approach probably would not be successful if principal payments were not required to be made until a such a distant point in the future that the present value of the obligation to make such payments were small. Compare S. Rep. No. 169, supra at 231.

ii. Preferential Distributions Creating Capital Account Deficit

The Tax Court in Otey recognized as a usual and customary partnership capitalization arrangement preferential distributions to a partner who put up a greater share of capital than her/his share of partnership profits in order to equalize the capital accounts of the partners. Otey v. Comm'r, 70 T.C. at 321. The Committee Report echoes this sentiment in stating that Congress did "not intend to prohibit a partner from receiving a partnership interest in return for contributing property which entitles him to priorities or preferences as to distributions, but is not in substance a disguised sale." S. Rep. No. 169, supra at 231. Unfortunately, the legislative history provides no guidance as to when such preferential distributions do and do not constitute a disguised sale.

The Committee Report does, however, address distributions that create deficit capital accounts. Such distributions frequently arise, for example, where a partner who has received a profits interest for services also receives a cash flow distribution. Such distribution may well not be currently taxable to the distributee partner to the extent that it and any tax losses have not exceeded the service partner's outside basis including his "share" of the partnership's inside liabilities. Leder, whose commentary and observations clearly form the secondary literature-substrata for the legislative history accompanying Section 707(a)(2)(A), addressed distributions creating a deficit balance in the partner's capital account through cash flow distributions. Leder, supra, 41 N.Y.U. Inst. on Fed. Tax. at 14-5. Leder reasoned that if the distributee partner were required to restore the deficit in his capital account, as he/she would be if the capital account maintenance rules of Treas. Reg. § 1.704-1(b) are followed, the cash flow distribution should be treated as cash distributions under Section 731 (taxable only to the extent in excess of the partner's outside basis) and not as payments under Section 707(a). Leder, supra at 14-5. The Committee Report generally agreed that Section 707(a)(2)(B) should not adversely affect distributions that create deficit capital accounts maintained in a manner consistent with Treasury Regulations § 1.704-1(b) "for which the distributee is liable, regardless of the timing of the distribution, unless such deficit capital account is improperly understated or not expected to be made up until such a distant point in the future that its present value is small." S. Rep. No. 169, supra at 231. This approach makes imminent sense and has been suggested by commentators in other areas in which capital account analysis is relevant save the basic provision itself. See Marich & McKee, supra, 41 Tax L. Rev. at 638-39 n.34.

Cash flow distributions to a service partner who receives a constant percentage of cash flow, income, and losses, often produces in the early years of a real estate tax shelter, particularly if not highly leveraged, a distributive share of tax losses and a cash flow distribution. If this distribution is respected as a distributive share, it will be tax free to the distributee up to
his/her basis and treated as a sale or exchange to the extent in excess thereof. I.R.C. §§ 731(a) and 741. Under the format of the legislative history, so long as the point at which such deficit must be restored is not too far distant, the distribution will be respected. At some point then, the partner will restore the deficit, thereby increasing her/his basis and reducing capital gain on the ultimate liquidation or sale of his/her interest. Alternatively, through taxable income in excess of cash flow, the service partner's deficit would be restored. Viewed in this manner, the distortion of income does not arise from a character change, but there is the timing abuse that Section 707(a)(2)(B) is essentially directed at. Perhaps the appropriate remedy here would be to charge the distributee partner interest at the applicable federal rate on the "deferred tax" on the distribution along the lines of new Section 453C(4)(B).

Leder pointed out that partnership drafting techniques could produce "payments" not too dissimilar substantively to Pratt, which generally prior to Section 707(a)(2) were respected as Section 704 allocations-cum-Section 731 distributions rather than Section 707 payments.

For example, general partners may receive a priority distribution as to cash flow based on a rental formula, with the distribution being fully chargeable to capital account. Depreciation deductions are often then specially allocated on a basis which is weighted heavily to capital (normally limited) partners. Remaining partnership income (i.e., without deduction for depreciation) is allocated first to cover cash distributions. Thus the capital account charged to the general partners would be offset with virtual certainty than income allocation each year. Should the allocation of income and distribution provisions be telescoped as a "payment"? Leder, supra, 41 N.Y.U. Inst. on Fed. Tax. at 14-12.

The legislative history of Section 707(a)(2)(B) addresses this question by pointing out that if the deficit creating distribution is coupled with an allocation of income or gain, the distribution/allocation arrangement may be subject to Section 707(a)(2)(A), although Section 707(a)(2)(B) will not apply. S. Rep. No. 169, supra at 231. In short, the thrust of Section 707(a)(2)(B) as to "entrepreneurial risk" is a large part whether the partner will be ultimately liable to repay the distribution. If not, then generally Section 707(a)(2)(B) deemed outsider transaction treatment applies.

Interestingly, the ALI Proposals would tax cash flow distributions to a service partner with a profits interest only if the distribution was within three years after the receipt of the interest, and several factors were met, primarily focusing on a partnership in which capital was material income producing factor and the service partner had not contributed capital to the partnership or assumed liability for indebtedness in proportion to his/her interest and the partnership was not principally a service partnership. See ALI, supra at 160.

The ALI Proposals also considered distributions that were required to be ultimately repaid to the partnership, but repayment was deferred for some time. The reporter suggested that an interest free loan should be treated as a
distribution under Section 731 (and perhaps then as a disguised sale under
Section 707 but this is not clear). ALI, supra at 178-79. [Query: Do the time
value of money rules apply in this context?]

b. Section 751(b): Disproportionate Distributions

The above rules alone would permit a partnership to distribute tax-free
property with a particular built-in character, e.g., ordinary or capital gain, to
a particular partner who could best utilize income of such character. To
preclude such asset selectivity, the 1954 Code introduced exceedingly
complex provisions in Section 751(b) which reconstruct a "disproportionate
distribution" of "ordinary income", i.e., Section 751(c) or 751(d) property or
"capital gains property" into a "constructive pro-rata distribution" of
whichever property the partner didn't receive his/her "share", i.e., Section
741 property, followed by a "constructive sale", producing the end positions of
the partner and of the partnership after the actual disproportionate
distribution, which can result in both recognizing a gain or a loss. This area is
further complicated by the fact that Section 752(b) treats a decrease in the
partnership liabilities as a "constructive cash" distribution which often will be
disproportionate if the partnership has certain types of assets, unless
precautionary special allocations are in place, e.g., a "revaluation" of assets
followed by Section 704(c)-like allocations or "segregation" of debt by
"minimum gain charge backs."

The apparent reality is that Section 751(b) is largely ignored, at least
where triggered by profit shifts. Passthrough Entities Hearings, supra at 61
(Rabinovitz); ALI, supra, 51 at n.5. "[T]he complexity § 751(b) introduces into
Subchapter K appears to overshadow its benefits." Id. at 52. Therefore, the
ALI Proposals recommended its repeal. Id. at 53. The old (ALI-1954) tax-
neutral reallocation among partners argument is saluted. Id. at 55. The
reality is that if Section 751(b) were eliminated and capital gains-ordinary
rate differentials persisted after 1987, something would have to be done
about flip-flop bottom line allocations. Probably mandatory revaluations and
Section 704(c)-like allocations would suffice. But what about time value of
money considerations?

2. Subchapter S

a. Introduction.

The S Corporation rules essentially take an entity approach as to
nonliquidating distributions. Thus there is no inside adjustment to reflect
outside basis adjustments as there is in the partnership arena.

b. Non-liquidating Distributions.

Under Section 1363(d) a non-liquidating distribution of appreciated
property triggers recognition inside the S Corporation. This gain then is
shared on a "pro rata" basis by all of the S Corporation shareholders. I.R.C.
§ 1377(a). At least as to ordinary income asset distributions, recognition is
thought by some preferable to an analogue of Section 751(b). See Hearings on
H.R. 6055 (Subchapter S Revision Act of 1982) before the Subcommittee on
Select Revenue Measures of the House Ways & Means Comm., 97th Cong., 2d
Sess. 215 (1982) (Statement of Martin Ginsburg) ("S Revision Hearings"); Staff
S Recommendations 17. The S Corporation shareholder receiving the property distribution in turn obtains a fair market value under the general corporate distribution rules in the property and is taxed only to the extent that the distribution exceeds his/her basis in his/her stock with the excess being treated as constructive sale or exchange. If, however, C E&P is present then the "AAA" tier rules kick into play. The potentialities for tax planning available here that are not available in partnership are obvious. A fair market value basis can be obtained at a tax cost of the other shareholders.

c. Liquidating Distribution in Kind

i. 1954 Code

Inside the S Corporation prior to the advent of the 1986 Code a liquidating distribution did not trigger the sale-exchange rule of Section 1363(d) as to appreciated property by virtue of Section 1366(e)(1). However, Sections 336 or 337, as the case might be, would apply under the incorporation by Section 1371(a)(1) of the not otherwise "inconsistent" general C Corporation rules. Therefore, the "recapture income" discussed in C to K conversions above would apply to the extent such items override Sections 336 or 337.

At the outside shareholder level, the "distribution rules" of Section 1368 did not apply since they were limited to Section 301(c), i.e., dividend-like distributions. Therefore again under Section 1371(a) the regular liquidation rules discussed above apply. If a Section 331 complete outside recognition-liquidation, albeit at capital gains approach, were taken, the distributed property would obtain a fair market value under Section 334(b). However, prior to the 1986 Code, Section 333 offered a practical alternative where there was no C E&P. S Revision Hearings, supra at 72 (David Glickman, Deputy Ass't Sec'ty). Because under Section 333, properly and timely elected, no gain was recognized to the shareholder except for capital gains equal to the cash and liquid assets received where there is no earnings and profits. (Earnings and profits were treated as a dividend.) At the same time the shareholder applied his/her outside basis, plus liabilities taken subject to or assumed, to the property received in the liquidation rather than fair market value. Thus under this approach a partnership-like liquidation consequence essentially could be achieved. This avenue was to disappear with the 1986 Code.

ii. 1986 Code

Under pre-1986 Section 1362(e) the non-liquidating distribution deemed sale rule did not apply so that old Section 336 did, Section 336 and 1363(e) permitted an outside basis increase with no inside toll charge other than "recapture," sometimes masking ordinary income. H.R. Rep. No. 426, supra at 279. Whether Section 341 caught this was problematical.

The House bill would have "retroactively" terminated the S election if a former C liquidated before the close of the second taxable year following the conversion year. Id. at 287. The Conference instead supplied new Section 1374's 10-year "taint." With no explanation in the legislative history, the 1986 Code revised the complete liquidation exception to Section 1363(d), by limiting the exception to "reorgs" under Sections 354, 355 or 356, I.R.C.
§ 1363(e) which contain their own inside recognition rules in "boot" distributions.

3. Conclusion

Ginsberg views the absence of an analogue in the S corporation tax rules of Sections 754 (governing inside basis adjustments) and 751(b) (the consequence of the tax-free carryover basis rules applicable to distributions, Sections 731 and 732) as an improvement. Ginsburg, Subchapter S and Accumulated E&P: A Different View, 17 Tax Notes 571 (Nov. 22, 1982). Treasury similarly views the optional basis adjustments as creating "administrative complexity." Passthrough Entity, supra at 15. It is true that the Section 743 and in particular the Section 751(b), but not to be overlooked the Section 704(b), regulations all do give complexity a new meaning. Thus, the aggregate approach to purchases, distributions and allocations allows the partners flexibility. But such flexibility generated tax-shelter abuse, i.e., uneconomic allocations of preferences, etc. This in turn gave birth to complex, preventative Code and regulation provisions, e.g., Sections 706(d)(2), 723, and 751(b) and Section 704(b) regulations and Section 707(a)(2) and 752 regulations to come. In an ideal world a nonliquidating distribution to an active participant S corporation shareholder, where there is no C E&P, should be tax free with a carryover basis. Instead an outside step up at the toll charge of an inside tax passed through proportionately to all the S corporation shareholders is provided by Section 1363(d). Unfortunately the partnership rules counterbalance that tax-free distribution flexibility with the Section 751(b) complexities and others to come. A similar S Corporation rule would entail the same. The inability for S Corporation to adjust its inside basis to reflect outside shifts interest is also unfortunate. Here too in the ideal S corporation world inside adjustments should follow outside adjustments just as Section 743 does if Section 754 is elected, or if "revaluations" and Section 704(c)-like allocations are made.

G. Purchase/Sale of a Partnership/S Corporation Interest

1. Subchapter K

   a. Partial Entity/Aggregate

      The 1954 House version of Subchapter K treated the sale of a partnership interest partially under the entity approach as a sale of a capital asset (Section 741) and partially under the aggregate approach as a sale of a proportionate interest in the underlying partnership "unrealized receivables" and "fees" (Section 751), regarding "the income rights as severable from the partnership interest and as subject to the same consequences which would be accorded an individual entrepreneur." H.R. Rep. 1337, supra at 71. The Senate adopted this partial entity sale of interest, partial aggregate sale of pro rata portion ordinary income assets approach, expanding the category to include "substantially appreciated inventory." S. Rep. No. 1622, supra at 99.

      i. Sections 751(a) and (b)

      Section 751 is aimed at two different problems: (1) use of the entity approach adopted in Section 741 applicable to the sale of an interest in the partnership to achieve outside partner-level capital gains when under an
"aggregate approach" ordinary income would result in whole or in part were there an entity-level sale of the selling partner's proportionate share of partnership assets with Sections 702(b) and 704 pass through of income and character; and (2) use of the aggregate rules providing for tax-free in-kind liquidating and nonliquidating distributions with a substituted or carryover basis through disproportionate distributions and retentions of capital gains and ordinary income property. In the partnership context the goal is not avoidance of an entity-level tax, but rather true transmutation of character. The aggregate approach of Section 751(a) to partnership Section 751(c) ordinary income assets effectively closes this loophole, albeit at the cost of substantial complexity.

Section 751(b) in practical effect applies an entity approach to "disproportionate distributions" of ordinary income and non-ordinary income property. As discussed above the distribution is recharacterized as disproportionate distribution followed by deemed sales between the partnership and the distributee partner to achieve the actual final result.

ii. Optional Inside Basis Adjustment

Both the House and Senate bill provided as does current Section 743(a) that generally the transfer of an interest portion of a sale or disposition does not affect the "inside" basis of the partnership's assets. S. Rep. No. 1622, supra at 96. Both bills provided, however, (as does current Section 743(b)) for an optional inside basis adjustment to reflect the increase or decrease in the acquiring partner's hand in the basis of the partnership interest transferred. The House assumed that such (in revocable) election would only be made if the basis increase were substantial so as to outweigh the "bookkeeping expense and inconvenience." H.R. Rep. No. 1337, supra at 70.

The House bill, following its entity-simplicity bias, allocated the Section 743 basis increase/decrease pro rata according to distributive share to all partners. H.R. Rep. No. 1337, supra at 70. The Senate, following the objections of the ABA, 1954 Code Hearings supra at 474, allocated the Section 743 inside basis adjustment entirely to the transferee partner "because it is more accurate than the House bill in reflecting the increase (or decrease) in basis to the partner to whom it is attributable." S. Rep. No. 1622, supra at 97.

Here Subchapter K follows as an initial matter an entity approach. The new partner has a cost basis under Section 1012 and Section 742 plus her/his share of the constructive cash contribution under the Section 752 regulation regime. If no Section 754 election is made and partnership property is distributed to him/her within two years after her/his acquisition of the partnership interest, the distributed property will be treated under Section 732(d) as having an inside basis in the partner's hands equal to the cost it would have had had there been a Section 754 election in effect. This is to ensure that the distributing partner is able in effect to apply her/his hypothetical inside cost basis under Section 732(d) to the distributed property. This is the partnership analogue to pre-1982 Section 334(b)(2).

If a Section 754 election is in effect, the partnership must adjust its inside basis, but only as to the transferee partner, in its assets (allocated under Section 755) up by the amount of any excess of the transferee partner's
basis in his/her partnership interest over his/her share of the adjusted inside basis of the partnership property (or decrease its inside basis by the excess of his/her share of the adjusted basis of the partnership property over his lower outside basis in his interest in the partnership) under Section 743(b). Otherwise, the partnership makes no adjustment to its inside basis due to the transfer of an interest in the partnership under the general rule of Section 743(a). Of course, the Section 732(d) two-year rule and Section 743(b) adjustments constitute an aggregate approach, whereas the general rule of Section 743(a) constitutes an entity approach.

The absence of a Section 754 partnership election may now be of "academic" in most cases. The last sentence of Treas. Reg. § 1.704-1(b0(2)(iv)(f) implies, properly in my view, that upon admission of a new partner or other interest shift, failure to "revaluate" partnership capital and implement Section 704(c)-type allocations of built-in gain or loss may violate, for example, the assignment of income doctrine. Id. § 1.704-1(b)(1)(iii).

2. **Subchapter S**

Here Subchapter S most clearly adopts an entity approach. A sale of a S corporation interest is treated as sale of an interest, generally capital unless the collapsible corporation provisions apply. And no inside basis adjustment is made.

a. **Collapsible Corporation**

Section 341 serves as a surrogate penalty principally designed to suppress at the shareholder level (and on occasion the corporate level in the case of a 1954 Code Section 337 transaction) liquidating distributions of contingent items to be collected by the shareholder after complete liquidation of the corporation. Under longstanding flawed, traditional doctrine before and after the 1954 Code a liquidating corporation avoided taxation at the corporate level upon distribution of a contingent claim and upon subsequent collection as well by the distributee shareholders if the liquidating corporation were not in existence at the time of collection, due to erroneous limitations of the assignment of income/clear reflection of income doctrine in its case law and statutory codifications to traditional tax accrual of income concepts. See Lee & Bader, supra 12 J. of Corp. L. at 187-206. At the same at the shareholder level such liquidating distribution of contingent claims without ascertainable fair market value could be treated as an open transaction with year one character treatment obtaining in year two (subject more recently to the time value of money principles after the 1984 revisions). Id. at 171-186. Rather than addressing the underlying inside corporate level escape, Congress chose instead the surrogate of converting the outside shareholder-level long-term capital gain into "ordinary income". Why such a conversion was thought to equate the escaped inside tax is unclear. Perhaps Congress felt it was simply ignoring the "collapsed" corporation through application of Section 341.

A nonliquidating distribution by an S corporation even if contingent income does not oppose the abuse potential that a liquidating distribution would since the S corporation under traditional doctrine will be taxed upon tcollection of the contingent item. Nevertheless, such a distribution usually would trigger the collapsible corporation provisions. At the same time a
liquidating distribution by an S corporation under the 1954 Code did pose collapsible and potential transmutation of income problems to the extent that the collapsible corporation provisions can be avoided which is often a case through several escape hatches.

3. Conclusion

The surface simplicity of the entity approach as to outside character is outweighed by the collapsible provisions, but as to sales and other transactions, other than non-pro rata distributions under Section 751(b), Sections 751(a) is probably less complicated than Section 341. Where owners materially participate inside basis adjustments should apply with mandatory revaluations, etc.

H. Business Combinations and Divisions

1. Subchapter K

Section 708 provides the basic rules for "continuation" and "termination" for tax purposes of a partnership. Section 708(b)(1)(B) mandates "termination" if within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. In the case of a merger or consolidation of two or more partnerships, the resulting partnership is the "continuation" of any merging or consolidating partnership whose members own a more than 50% interest in the capital and profits of the resulting partnership. Similarly, in the case of a division of a partnership into two or more partnerships, the resulting partnerships in which the members had an interest of 50% or more in the capital and profits of the prior partnership are considered a continuation of the prior partnership. Where the prior partnership terminates, the partnership year closes on the date of the tainted sale or exchange.

The terminating partnership is deemed to distribute its properties to the purchaser and the other remaining partners in proportion to their respective interest in the assets under Treas. Reg. § 1.708(b)(1)(iv). Following this constructive distribution, the buyer and the other remaining partners are deemed to have constructively contributed the "distributed" properties to a new partnership in a transaction governed by Section 721, etc. In such a constructive liquidation and recontribution transaction, a revaluation of partnership properties and a restatement of partnership capital accounts to reflect such fair market value is permitted, probably even required if an "aggregate" concept is applied (at some point, if enough of your partners change, you no longer are the same aggregate of partners), under Treas. Reg. § 1.704-1(b)(2)(iv)(f). In such a revaluation adjustments consistent with Section 704(c) principles are necessary. See, id., 1.704-1(b)(2)(iv)(g). If, as likely as to be the case, the "terminated" partnership contains property other than money, then in this deemed distribution the property and capital accounts must be restated by virtue of Treasury Regulations § 1.704-1(b)(2)(iv)(e)(1). Thus, the essential difference between continuation or termination appears to be whether revaluation is mandatory or optional and in the case of termination the reconstituted partnership presumably treated as a new entity with new elections relating the accounting methods, depreciation and other matters. However, such elections have been increasingly ever more circumscribed by statutory reform and apparently were the chief reasons for
the "termination" rule. See Passthrough Entitles Hearings, supra at 62 (Rabinovitz); All, supra at 101 n.1. It is probable that suspended Section
704(e) losses terminate upon a termination of the partnership. For Section
704(d) provides that a suspended loss is allowed "as a deduction at the end of
the partnership year in which such excess is repaid to the partnership." (Emphasis added.)

2. Subchapter S.

Here too is an area in which the general corporate rules apply. Thus, an
S Corporation may be merged with another S Corporation or with a C
Corporation so long as the corporate reorganization rules are met. A
technical problem that may arise is that generally stock ownership in an S
Corporation is limited to an individual or certain qualified trust under Section
1361(b)(1). Furthermore, an S Corporation cannot be a member of an
affiliated group, which precludes ownership by it of 80% or more of a
subsidiary. Certain reorganizations require that a target corporation stock be
owned perhaps momentarily by another corporation. Furthermore, certain
acquisitive reorganizations require that the organizing corporation control a
subsidiary for at least a transitory moment. Fortunately the Service has
ruled that mere transitory ownership of S Corporation stock by another
corporation or of a controlled subsidiary by an S Corporation will be ignored
so long as the S Corporation as part of the transaction in the final step meets
the stock ownership and ineligible corporation definition requirements of
Section 1361.

As to corporate divisions there are both technical and frequently
practical problems. The technical problem is that a corporate division often
requires the old corporation to establish a subsidiary at least momentarily.
Fortunately a momentarily established subsidiary or other alternatives can be
devised for meeting Section 355 without jeopardizing S Corporation status.
The practical problems are that Section 355 requires in part that a divided
corporation be conducting a five year or older active business that was not
acquired by the dividing corporation in a cost basis acquisition. For new
service corporations this may be an insurmountable problem. See Lee, How
to Salvage Tax Benefits When a Professional Corporation Dispanels, 45 J.
could obviate this problem in part by a Section 333 liquidation provided that
the other shareholders were willing to shift out of corporate status. With the
repeal of General Utilities, this avenue is closed.

Unlike the Section 708 rule, shifts in S corporation stock ownership do
not terminate the entity. Although a 50%+ shift can set the stage for a
reconsideration of the S election. See I.R.C. § 1362(d)(1B).

The partnership approach as to both combinations and divisions is to
categorize transactions on the basis of whether (a) the resulting partnership
constitutes a "continuation" without termination of the partnership in
question or (b) the entire transaction constitutes a constructive liquidation in
kind of the old partnership followed by a contribution in kind by the
continuing partners to the new partnership. I.R.C. § 708(b)(2) "Continuation
or termination turns on whether there is more than a 50% change in capital
and profit/losses of the old partnership within a 12-month window ending on
the transaction in question under the Section 708 standards. I.R.C.
§ 708(b)(2)."
A Subchapter S corporation is subject to the general corporate rules regarding reorganizations, both acquisitive and divisive, although more than "transitory" existence as a member of an "affiliated group" can cause "status" problems. Prior to 1986, however, an S Corporation without C E&P had available the partnership-like avenue of a Section 333 liquidation so long as the shareholders of the liquidated corporation did not reincorporate all or part of the assets into a new corporation as a part of a step transaction. The acquisitive reorganization rules are probably posed less problems so long as the transaction was kept simple. On the Section 355 divisive reorganization side, however, the "active business" test and "device" tests often pose qualification problems particularly as to new service corporations. See Lee, supra, 45 J. Tax. 14.

3. Conclusion.

Clearly the partnership is the easier vehicle for mergers with other partnerships and divisions. The S Corporation rules are both too complicated and too simple: (a) They are too complicated due to the general corporate rules and (b) they are too simple in that they would allow tax free shifting from conduit S Corporations status to separate C Corporation status in a merger of an S Corporation with a C Corporation with the latter surviving. For the reasons discussed in S to C conversions this rule is too simple.

I. Estate Planning

1. Introduction

Historically the closely-held C corporation has been the prime candidate for estate planning, particularly in the context of an "estate freeze". An estate freeze seeks to transfer future appreciation to other taxpayers, generally the younger generation. In the closely-held C corporation context the principal means of estate freezes has been through (1) the Section 351 formation of a holding company with preferred stock (which holds all of the stock of the operating company), (2) a recapitalization changing common stock into preferred stock or (3) a preferred stock dividend. Generally all three methods result in the preferred stock coming under Section 306. At the opposite extreme lies an S corporation. Since it can have no second class of stock, the ability to effect an estate freeze is quite circumscribed. The principal method would be through creative use of debt instruments. However, if the debt instrument is not issued in an initial incorporation, the issuance of the debt most likely will constitute a dividend to the recipient. In between these two extremes lies a partnership capital freeze.

A partnership capital freeze is implemented by forming a new partnership or by restructuring an existing partnership to provide for at least two classes of partnership interests: (1) a 'frozen' or 'preferred' partnership interest with a fixed liquidation preference and preferred rights to income and distributions; and (2) a 'regular' or 'common' partnership interest with a residual claim to the partnership's assets, earnings and distributions. The resulting multiple class partnership may be either a general or limited partnership. The older generation family member receives the 'preferred'
partnership interest and members of the younger generation receive the 'common' partnership interests. Control and management responsibilities may be allocated to either the 'preferred' or 'common' partnership interests or to a separate class of partnership interests created solely to control and manage the partnership. Elias, The Partnership Capital Freeze: A Path Through the Maze, 40 Tax Law. 45 (1986).

2. Subchapter K Estate Freeze

The primary purpose of a partnership capital freeze is to reduce estate and gift taxes for the older generation, but additional consequences may include cash flow to the older generation; possible income tax savings through income shifting (discussed in subparagraph i below); and flexibility in allocating management responsibility, risk-taking, and control of the business Elias, supra, 40 Tax Law. at 45.

A partnership capital freeze entails not only consideration of whether the freeze does in fact accomplish the estate tax objectives, but also the basic question of whether the mechanics themselves are respected. The latter involves consideration of both the "family partnership" provisions of Section 704(e) and the allocation provisions of Section 704(b).

Capital must be an material income producing factor. See Elias, supra, 40 Tax Law. at 47; for other Section 704(e) problems see id. at 48-49.

Conversion or recapitalization of partnership does not in itself give rise to taxation. Id. at 50. But constructive cash distributions from a change in profit-loss ratio in such a conversion can give rise to problems. Article suggests use of guarantee. Elias, supra 40 Tax Law. at 57.

Estate freeze allocations have substantial economic effect. Id. at 54; for other estate tax and gift tax issues, see id. at 61-71.

3. Subchapter S Estate Freeze

The core problem here is the S corporation prohibition of multiple classes of stock. The narrow exceptions for non-voting common stock, etc., are not helpful in effectuating an estate freeze. An estate freeze in an S corporation context usually must turn on creative use of debt. Fortunately as long as a straight debt instrument is used no second class of stock issue is posed.

Issuance of a debt instrument by an existing corporation other than an exchange for property gives rise to dividend potentiality at the shareholder level. After the 1982 changes to Section 304 use of a holding company does not avoid this problem. Only initial issuance of debt under current rules (likely to be changed) gives rise to no dividend consequences. Even so use of debt instruments appears awkward.

Other suggested means of achieving life-time estate freeze effects in an S corporation's setting include (1) a private annuity, (2) an installment sale, and (3) a combination of an S corporation and a partnership. A private annuity can be a somewhat leaky tax shelter. If the seller of the stock dies
early, he/she will have received few payments and the annuity is not includable in his/her estate. On the other hand, if the seller of the stock survives beyond his/her life expectancy, while the annuity is still excluded, more payments will have been received by the decedent, which in turn would have to be disposed of to reduce the estate. Also, the private annuity approach results in giving up all voting control in most circumstances. An alternative approach to the annuity transaction is for the shareholder to contribute the S stock to a grant or trust reserving an annuity from the property for a specified period. The trust income would be taxed of the grantor and the value of the corpus is includable in the estate if the grantor does not out live his/her annuity interest.

The installment sale of stock has an effect similar to that of a private annuity by converting the value of the S stock into a debt obligation with a fixed value. However, the installment sale approach yields more certainty because fixed payments generally are to be made rather than an annuity turning on the number of years the seller lives. A variant of a self-cancelling installment note has been suggested here with the potentiality (probably weak) that the cancellation of the note as the seller's death will not constitute a disposition of the installment obligation triggering recognition to the estate. The above list focuses on life time estate freezing alternatives. Disposition at death can also be structured into a "freeze" under a binding by-sale agreement which fixes the estate tax value of the decedent's S corporation stock.

Beyond the second class of stock rule, a number of other S corporation prerequisites pose potential traps, or at least warnings, in S corporation estate planning. Thus, the permitted ownership requirements (number of shareholders, categories of shareholders, etc.) must be carefully attended to prior to death. Estate planning, by buy-sell agreements or by terms of the wills of S corporation shareholders should be coordinated with the numerical and categories of permitted shareholders restrictions. Sound tax planning also calls for contractual penalties to be imposed upon violators by will or sale.

P.L.R. 8711020 recognizes an S corporation as partner where it sells half of its going business to a unrelated company who then becomes a joint venturer with the S corporation in operating the old business. See Freeman, *Some Early Strategies, etc.*, 64 Taxes 962 (1986), on roll-outs and roll-ups for estate freeze effects.

J. **Family Income Shifting**

1. **Subchapter K**

Congress in enacting in 1951 the predecessor to Section 704(e) restated the assignment of income principles as follows:

Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services... [The amendment] makes it clear that however the owner of a partnership interest may have acquired such
interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him, or whether the business benefited from the entrance of the new partner. S. Rep. No. 781, 82d Cong., 1st Sess. 38 (1951).

The Supreme Court in Comm'r v. Culbertson, 337 U.S. 733 (1949), also looked at services and capital, but its analysis was not whether the services or capital contributed were of sufficient importance to meet some objective standard, supposedly established by the Court in Comm'r v. Tower, 327 U.S. 280, 290 (1946), which articulated the issue in the family partnership context as "whether the partners really and truly intended to join together for the purpose of carry on business and sharing in the profits or losses or both." Culbertson reasoned that the question instead was

whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the ownership of parties, their respective abilities and capital contributions, the actual control of income and purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Section 704(e)(1) provides that a person will be recognized as a partner for purposes of the partnership tax provisions "if he owns a capital interest in a partnership in which capital is a material income-producing factor..." The regulations, however, accompanying this provision incorporate to a large degree the case law focus in requiring the gift or other transfer of capital to meet certain basic tests for the donee or purchaser to be treated as the "real owner" of the capital interest. The regulations turn on retained direct and indirect controls, which would preclude the vesting of dominion and control of the partnership interest in the transferee. Participation in management, income distributions, and conduct of partnership business, or lack thereof, also constitute relevant factors. Generally a minor is not recognized as a partner unless control of the partnership interest is a exercised by another person as a fiduciary under judicial supervision acting solely for the minor's benefit.

Once the basic test of "real ownership" is satisfied, the issue narrows to whether capital is a "material income-producing" factor in the particular partnership. The regulations draw the bright line of (a) capital not being a material income-producing factor where the business income consists principally of compensatory income from services on the one hand, and (b) capital ordinarily constituting a material income producing factor, on the other, if the business requires substantial inventories, or a substantial investment in plant and machinery or other equipment. See summation of case law at 37 Tax Law. 275.

If the taxpayer fails either the true ownership or capital as a material income producing factor test, then the statutory presumption of partnership status does not apply. But in that case the common law test fashioned by the Supreme Court in the family partnership cases including Tower and

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Culbertson generally governs. If the purported partner performs services for the partnership, then the regulations to be promulgated under the 1984 amendments to Section 707 are to provide for partnership status.

Once partnership status is attained by virtue of a capital interest, case law factors, or Section 707(a)(2) analysis by performing services for, or transferring property to, the partnership, the second leg of the statutory codification of the assignment of income doctrine in Section 704(e)(2) comes into play provided that if the partnership interest was created by a gift or purchased by one family member from another. Section 704(e)(2) recognizes the distributive share of the donee-purchaser from family member partner under the partnership agreement except to the extent that such a distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor or to the extent that the portion of such distributive share attributable to capital is proportionally greater than the share of the donor-family member seller attributable to his/her capital. The "reasonable allowance" for services rendered by partners is determined essentially under the Section 162 reasonable compensation standards. Query, what happens in a loss situation?

2. **Subchapter S**

The S corporation provisions contain no statutory analogue to Section 704(e)(1), i.e., recognition of the taxpayer as a partner if capital is an income-producing factor. But the S corporation case law springs from the same assignment of income well from which Congress drew Section 704(e)(1). Thus the Tax Court in Duarte v. Comm'r, 44 T.C. 193 (1965), treated transfers of S corporation stock to minor children as not being bona fide or economically real despite the appointment of a custodian for the children where (a) neither the children nor the custodian exercised any influence in the operation of the corporation, and (b) the children did not receive any of the income which the S corporation reported as having been distributed to them. The Tax Court similarly found a transfer of S corporation stock to children to be not bona fide where there were no purported distributions of S corporation earnings, but the father of the children and principal employee of the corporation obtained the use of the undistributed taxed S corporation income through large, unsecured advances which were not repaid. See generally, Heller, Shifting Family Income Through Subchapter S Corporations: Problems and Planning, 5 J. Corp'n Tax. 157 (1978). See Beirne v. Comm'r, 61 T.C. 268 (1973). Furthermore, the pre-1982 S corporation regulations provide to similar effect:

A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized. Treas. Reg. § 1.1373-1(a)(2).

In essence, while through a somewhat different route, the same result that should obtain as to recognition of an S corporation shareholder as to recognition of a partner in the family partnership context.
Once the S corporation shareholder is treated as the true owner, Section 1366(e) applies a somewhat more limited "deflection of income" provision modeled on Section 704(e)(2). The S corporation rules provide that the Service may make "adjustments in the items taken into account by (a) an individual, related to one or more shareholders in the S corporation, who renders services, or furnishes capital, to the S corporation without reasonable compensation and (b) such related shareholder(s) in order to reflect the value of such services or capital. The Senate Finance Committee Report explains that

[Items taken into account by members of the family (whether or not themselves partners) wherever it is necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation may be properly adjusted. Both the amount of compensation and the timing of compensation can be so adjusted. S. Rep. No. 640, 97th Cong., 2d Sess. 17 (1982).]

The above legislative history, consistent with the fact that Section 1366(e) can apply to a nonshareholder, implies that the Service has the power under this provision to allocate, presumably much like Section 482, compensation income (for services or capital, i.e., interest) to the under compensated individual and at the same time to create or allocate to the S corporation a corresponding deduction. In contrast, the partnership provisions appear merely to readjust the partner's distributive shares of income. Of course there an individual providing services, transferring property or investing "material" capital would be a partner under either Sections 704(e) or 707(a)(2)(A). On the other hand, some commentators believe that instead Section 1366(e) contemplates a reallocation of specific items of corporate income and perhaps expense among the family members as their "pro rata share". If this approach were followed, conflicts with the rule that pro rata share is based upon stock ownership would arise, requiring perhaps imputed stock ownership.

The pre-1982 Subchapter S rules followed neither of the above patterns. Rather if a shareholder-employee received either excessive or inadequate compensation (the prior provision being limited to services rendered to the corporation by family member shareholders), the amount reallocated was treated as a Subchapter S corporation dividend and not as compensation for services. This approach appears closer to a passthrough model than to a reallocation of income or loss items. On the other hand the 1982 legislative history refers to the timing of compensation, and allocations impacting on timing are more consistent with Section 482 allocations than distributive share reallocations.

3. Conclusion

Income shifting in Subchapters K and S contexts faces common-law assignment of income and partial legislative codifications of that doctrine. The partnership provision (Section 704(e)) is more detailed than the corresponding S corporation provision (Section 1366(e)).

Section 704(e)(1) recognizes a person as a partner if he owns a capital interest in a partnership in which capital is a "material income-producing
factor." Once a partner is recognized, then the distributive share of a donee (or a purchase by a member of the seller's family) is recognized only after an allowance for reasonable compensation for services rendered to the partnership by the donor and if the portion of such share attributable to donated capital is proportionately the same as the share of the donor attributable to the donor's capital.

Parallel S corporation rules are limited to reallocations for reasonable compensation or return on capital. However, under the case law and other authorities the Service closely scrutinizes transfers between family members to determine if the donee (or purchaser) is the "real owner" of the stock. Treas. Reg. § 1.1373-1(a)(2).

J. Death of Owner

1. Subchapter K

At a partner's death, his/her interest in the partnership can be (1) continued by his/her successor in interest; (2) sold (pursuant to a buy-sell agreement in place at date of death) to the other partners; or (3) liquidated by the partnership, generally with continuing Section 736 payments. In all three cases the value of the partnership interest, including the distributive share of income or loss at the date of death is includable in the decedent's gross estate.

The partnership year generally does not close as to a partner who dies prior to the end of the partnership taxable year. But if the decedent partner's estate or other successor sells or exchanges later in the tax year the decedent's entire interest in the partnership, the partnership taxable year as to the estate or other successor closes on the date of such subsequent sale or exchange. Similarly if the entire partnership interest is liquidated later in the tax year, the partnership year closes on the date of the completion of the liquidation as to the estate or other succession. However, such liquidation may coincide with the end of the partnership tax year. Moreover, if continuing Section 736(a) payments are involved, the liquidation is not completed until the payments are completed.

The final return of a decedent partner includes only his/her share of partnership taxable income for any partnership taxable year ending within or with the last taxable year of the decedent partner (the year ending on the date of his/her death). If the partner's estate or other successor in interest continues to share the profits or losses of the partnership, the partnership taxable income for the entire partnership taxable year ending after the decedent's last taxable year is included in the return of the estate or of the successor. (Thus, if the partnership is generating net losses for the entire year and the decedent partner had substantial income in his/her final year, the decedent's surviving spouse, if any, should be the successor in interest, so that the losses and income could be netted on a final joint return. Such successor in interest must be designated in accordance with the terms of the partnership agreement.)

Conversely, a sale or exchange of the decedent partner's interest pursuant to a buy-sell agreement existing at the date of the death of a partner, results in a close of the taxable year of the partnership as to such
decedent partner at the date of death which is also the date of the sale or exchange.

The distributive share of partnership income as of the date of death of the decedent partner constitutes Income in Respect of a Decedent ("IRD"). Hence, the successor in interest takes a carryover basis in IRD items, generally zero in the case of a cash method decedent's receivables. And the recipient successor characterizes the IRD items under Section 691(a)(3) in the same manner as if they had been received by the decedent. These provisions are more-or-less meshed with Section 751 through the case law.

With advance planning, the partners can arrange for the decedent partner's year to end with the date of his/her death through a buy-sell agreement. Furthermore, if the partners decide to transfer the decedent's interest through a sale or exchange to the remaining partner(s), such form is respected rather than treating the transaction as a liquidation of the partnership. Consequently, the sale or exchange of the interest to the other partner(s) results in a capital gain under Section 741, except to the extent that Section 751(a) applies. As discussed in more detail above, under Section 751(a) a sale of the partnership interest under an aggregate approach will nevertheless trigger a deemed sale as to the selling partner of his/her pro rata share of partnership Sections 751(c) and 751(d) assets. Since in this deemed sale the selling partner is deemed to have received a distribution of the Sections 751(c) and (d) assets with an inside basis flow through immediately prior to the sale, the estate's basis in the partnership interest and in the Sections 751(c) and (d) is critical. As discussed above, to the extent that the items constitute IRD, no step up occurs. Thus true "accounts receivable" constitute IRD with no inside step up. The interesting, and as yet not finally resolved question is whether potential recapture, a constructive Section 751(c) asset is stepped up (as would be the case if the decedent held the depreciable depletable asset directly—death purges the recapture taint) or constitutes IRD.

If the sale approach is chosen, and no Section 754 election is in effect, then the purchaser obtains no inside basis adjustments (except for Section 732(d)). If however such an election is in effect, the purchaser obtains an inside basis adjustment under an aggregate approach as if he/she had purchased his/her proportionate share of partnership assets for their fair market value at the time of acquisition of the partnership interest.

The partners also may choose for the partnership to liquidate the decedent partner's interest. Upon completion of the liquidation of the decedent partner's interest, the partnership year closes as to such partner. Thus, the partners can control the closing of the year. Moreover by agreement under Section 738(b) the partners may allocate the tax burdens as they choose, with a minimum of uncertainty and difficulty, at least as to stated and unstated good will.

The intended purpose of this provision was to permit the participants themselves to determine whether the retiring partner or the remaining partners would bear the tax burdens for payments in liquidation of a retiring partner's interest. Thus, under the general approach of subsection [736](a), the tax burden is borne by the retiring partner—he
recognizes the payments as taxable income, and the remaining partners are allowed a commensurate deduction from partnership income. [Literally in the case of a "guaranteed payment", figuratively in the case of a distributive share.] Under subsection [736(b), the general rule concedes an approach of nonrecognition of ordinary income to the retiring partner, but places the tax burden on the partnership by denying a deduction from income for the payments. This latter provision, however, adopts a special rule—[subsection 736(b)(2)(B)—in an express effort to assist the participants to decide inter sese upon the allocation of the tax burden... Under this rule, payments for the good will of the partnership are deductible by the partnership (and hence recognizable as ordinary income to the retiring partner) "except to the extent that the partnership agreement provides for a payment with respect to good will." If the partnership agreements provides for a payment with respect to good will, the tax burden is allocated to the partnership—no deduction is allowed and the retiring partner need not recognize the payments as ordinary income. Commissioner v. Jackson Investment Co., 346 F.2d 187.

Thus, the parties have the ability to state or not state good will and thereby effect Section 736(a) or Section 736(b) treatment as desired. Moreover, to some degree turning on the partnership agreement the parties have an ability to allocate premium between unrealized receivables and stated good will under the Fixel decision.

If a partnership election is in effect under Section 754, then the partnership will increase the inside adjusted basis of partnership property by gain recognized to the distributee partner in exchange for his partnership interest under Section 736(b), 731(a)(1), and Section 741. Otherwise no inside basis adjustment will be made by the partnership due to the liquidation, nor will it recognize income on the liquidation, even as to distributions of property and kind.

2. Subchapter S

In the S corporation context there are also three possibilities: (1) the estate or the decedent shareholder's successor in interest continues as the S corporation shareholder; (2) the estate or other successor in interest sells the S corporation stock whether or not pursuant to a buy-sell; or (3) the estate or other successor's stock interest is redeemed by the S corporation. In all three scenarios, the decedent shareholder's final return includes his/her pro rata share of S corporation income and loss for its tax year in which the decedent dies. In and all three cases the accrued income is includable in the estate. Thus there is less flexibility, but also less traps for the unwary, in the Subchapter S regime.

As to sale or liquidation of the decedent's stock interest, essentially the same results obtain so long as family or other attribution is not involved. Due to the S corporation stock ownership restrictions, usually family attribution would be the only attribution involved. Except in exceeding limited circumstances, an estate cannot the waive the attribution; therefore, stock
owned by family members most likely will have to be taken into account in the case of a redemption by the S corporation. If a redemption does not quality as a sale or exchange due to attribution, then it is treated as a Section 301 distribution and for S corporation purposes as a distribution under Section 1368.

Regardless of whether continuation, sale, or redemption is chosen, no inside basis adjustment is made by the S corporation as to the transferee or remaining shareholders.

As to continuation by the decedent's successor and interest, the ownership restrictions of Section 1361(b) and (c) must be kept in mind. Particularly the prohibition of all save quite limited trusts as permitted S corporation shareholders poses traps for the unwary here.

3. **Conclusion**

Again the partnership vehicle offers the maximum flexibility, particularly as to the deceased partner's distributive share of partnership income for the partnership year in which the partner dies. Who is taxed on that distributive share of income turns on which of three scenarios are chosen as to the decedent's interest in the partnership. (1) The interest in the partnership can be continued and acquired by the deceased partner's successor-in-interest; (2) the decedent's interest can be sold, for example pursuant to a buy-sell agreement, to the remaining partners and an agreed upon valuation; or (3) the partnership interest can be liquidated by the partnership under Section 736 pursuant to a preexisting agreement as well. If the partnership year ends at the deceased partner's death, which is the case only if alternative two of a sale is chosen, the deceased partner's share of partnership income or loss up to the date of his/her death is included in the deceased partner's final income tax return covering the period from beginning of the calendar year as a usual matter through the date of his/her death. Otherwise, in the case of continuation by a successor in interest or Section 736 liquidation, the partnership's year is not closed as to the deceased partner and his/her entire partnership Section 702 distributive share of partnership income or loss passes through to his/her successor in interest. In all three cases the value of the accrued partnership income at date of death is includable in the decedent's estate. In the case of a continuation or Section 736 liquidation, such accrued income constitutes income in respect of a decedent ("IRD") and is not stepped up or down at death. Other tax consequences of the continuation, sale or liquidation methods also vary. Indeed the entire area offers great flexibility, but equally great traps for the unwary.

As to S corporations, the picture is much simpler and less flexible. Regardless of whether (1) the estate or other successor in interest to the deceased S corporation shareholder remains a stockholder in the S corporation; (2) the stock interest is sold to other shareholders, (a) pursuant to buy-sell arrangement or (b) not; or (3) the S corporation stock interest of the deceased shareholder is redeemed by the S corporation, the decedent is taxed on his/her pro rata share of the S corporation's items of income or loss under Section 1366(a)(1). This provision specifically refers to the final taxable year of a shareholder who died before the end of the corporation's taxable year. Of course, the pro rata share only reflects the stock ownership
by the decedent during the tax year, and the successor or other transferee takes into account his/her pro rata share for the balance of the S corporation's tax year. Additionally assuming no family attribution, the results at the decedent shareholder's estate level are the same regardless of whether the stock is sold to others or is redeemed.

K. Owner Buy-Outs

1. Subchapter K

One of the few partners' choice provisions left substantially unchanged in the recent wave of anti-abuse partnership amendments is Section 736 governing payments to retired partners. Even here, the legislative history to the 1984 amendments to Section 707 calls for conforming amendments to the Section 736 regulations.

a. Section 736 Retirement/Liquidation Payments

Section 736 divides payments to a retiring partner (or successor to a deceased partner) into two broad categories: (1) payments for the partner's interest in partnership property, and (2) all other payments. Broadly, amounts paid for the partner's interest in partnership property are treated as a constructive sale or exchange yielding capital gains income. Other payments are treated as attributable to a continuing share of partnership income, i.e., a Section 704(a) or (b) "distributive share" or a Section 707(c) "guaranteed payment," as the case may be. "Unrealized receivables" and "inventory items", the heart of the collapsible partnership provisions (Section 751), are treated specially under an intricate interweaving of provisions.

i. In-Kind Distributions

Pro rata in-kind distributions of unrealized receivables and inventory items, being specifically excluded from sale or exchange treatment under Section 736(b), at first blush fall into Section 736(a), which provides for distributive share (Section 704(a) or (b)) or guaranteed payment (Section 707(c)) treatment, according to whether dependent upon partnership profit or not. Arguably an in-kind distribution rather than cash payment is tax-free with a substituted tainted character. I.R.C. § 731, 732 and 735. Non-pro rata distributions of property other than unrealized receivables, while superficially under Section 736(b), are really subject to Section 751(b), which restructures the disproportionate distribution as a "constructive" pro rata distribution of non-Section 751(c) property and Section 751(c) property i.e., unrealized receivables and inventory. This restructured constructive pro rata distribution is followed by "deemed," i.e., constructive, sales and exchanges between the partner and the partnership to achieve the final actual disproportionate result. Thus, the distributee partner will most likely be deemed to have sold his/her deemed proportionate share of unrealized receivables and inventory items back to the partnership resulting in immediate ordinary income and recognition due to the interplay of Sections 751(b) and 735 (which carries over the inventory taint for five years in the distributee partner's hands).
ii. **Payments for Interest: Constructive Sale or Exchange**

Payments for a partner's interest in partnership assets other than "unstated" good will and unrealized receivables are in effect treated under Section 736(b) as a constructive sale or exchange of the partner's interest in the partnership. For such payments are treated as a constructive cash distribution, which results in recognized income to the distributee partner only to the extent in excess of his/her basis in his/her partnership interest. Of course, such basis must be allocated between Section 736(b) partnership property and unrealized receivables and other Section 751(c) property.

iii. **Payment for "Profit Share"**

Other payments, i.e., payments for pro rata interest in unrealized receivables and inventory and unstated good will, fall into Section 736(a). Section 736(a) is intended to treat such payments in effect as a continuation of the partner's profit share, i.e., to the extent payable only out of partnership profits treated as a distributive share under Section 704(a) or (b) and to the extent payable without regard to partnership profits, treated as a guaranteed payment under Section 707(c). Such treatment of unrealized receivables and inventory follows from their "ordinary" nature. The treatment of unstated goodwill is due rather to a concession to the policy of flexibility between partners: they can choose whether (a) to "state" goodwill, in which case it will be a Section 736(b) constructive sale or exchange item, or (b) not to state goodwill, in which case the distributee partner would recognize ordinary income (or other flow through character of partnership income), thereby reducing the other partner's shares of income (or giving them a deduction in the case of a guaranteed payment).

The Internal Revenue Service apparently prefers an approach that determines each partner's share of Sections 751(c) or 751(d) property on the basis of his/her interest in the partnership. The Tax Court, however, has looked to the partnership agreement to determine whether a retiring partner has any interest in unrealized receivables. If he/she does not, and the agreement indicates that payment is for "stated good will", then a partner may be able to obtain entirely sale or exchange treatment upon the liquidation of his/her interest in the partnership even where the partnership contains substantial unrealized receivables. These rules apply even in a two-person partnership in which one partner retires. As long as Section 736(a) payments are due the retired partner, the partnership is deemed to continue under the regulations.

Some pre-1984 commentators believed that Section 736(a) payments, particularly the "guaranteed payments", were deductible under a technical reading of the statute without regard to the general capitalization or other rules normally applicable to "ordinary" payments. This reading was supported by the legislative history accompanying the 1976 amendments to Section 707(c), codifying Cagle. S. Rep. No. 938, 94th Cong. 2d Sess. 94 n.7 (1976). However, the legislative history to the 1984 changes to Section 707(a)(2) mandates incorporation of the principles of those amendments in the Section 736 regulations. S. Print No. 169, supra at 228. Hence, where payments to a retiring partner are attributable to services performed by him/her and the payment is deemed under Section 736(a) to be a guaranteed or non-partner payment, the general capitalization (and non-amortization for syndication
costs) rules should apply as to such guaranteed payments. The question of employee status remains to be resolved.

b. **Partner Cross-Purchase**

Instead of the partnership liquidating the retiring partner's interest, the remaining partners can instead purchase the interest. Different tax consequences result and the choice is that of the partners. As to the selling partner, the sale of a partnership interest is treated as the sale or exchange of the interest under Section 741, an entity approach. However, to the extent of the selling partner's interest in unrealized receivables, Section 751(a) a modified aggregate—fragmentation of assets approach applies. Under it the selling partner is deemed to have had a in kind distribution of his/her share of partnership Section 751(c) assets immediately prior to the sale. As to such deemed distribution, the selling partner takes over the partnership's inside basis, generally zero in the case of unrealized receivables (Sections 732(d) or 734(b) would apply to such hypothetical distribution). The selling partner is then deemed to have sold the deemed distributed Section 751(c) assets to the purchaser and to have sold the rest of his/her partnership interest for a capital gain or loss, against which he/she offset the rest of his/her remaining basis, to the purchasing partner for the remaining purchase price. The old result of ordinary gain and corresponding capital loss becomes untenable on a policy basis if the capital gains preference does not return.

The purchasing partner in contrast is treated under an entity approach as having purchased the partnership interest in which he/she has a cost basis under Sections 742 and 1012 (plus share of liabilities under Section 752(a)). No inside basis adjustment is made to the partnerships assets for the benefit of the purchasing partner (except the two-year Section 732(d) rule as to distributions within the two years following the purchase), unless a Section 754 election is in effect. In essence, through a sale a selling partner can convert unstated good will into capital gain, which would not be possible in a liquidation.

c. **In-Kind Liquidation**

A third, and probably less frequently chosen, alternative is an in kind liquidating distribution to the retiring partner. While the law is somewhat unclear here, as discussed above, such liquidation should be a nonrecognition event with substituted basis and carryover taint for five years. Unstated goodwill "distributed" should not be recognized either. A distribution of Section 751(c) or (d) property should not be treated as a liquidating payment for such interest. Rather they should be treated as Section 735 5-year tainted distributions.

2. **Subchapter S**

a. **Outside Retiring Shareholder Treatment**

The starting point is that the S corporation provisions contain no parallel to Section 736. Rather the S corporation provisions are silent as to the outside retiring shareholder's treatment in a redemption or, for that matter, partial liquidation or complete liquidation. Therefore, for the redemption or partial liquidation transactions, by virtue of Section 1371 we must look to Section 302.
If Section 302(b) applies, under Section 302(a) constructive sale or exchange treatment results of the shareholder level unless Section 341, applicable to collapsible corporations, is triggered. In broadest outline, Section 302(b) requires for shareholder-level constructive sale or exchange treatment that the shareholder surrendering stock to the S corporation in a redemption either (a) to surrender all or a substantial portion of his/her stock (and the other shareholders are unrelated or the complete termination of interest waiver under Section 302(c) of Section 318 family attribution rules apply) or (b), coupled with a redemption, to sell a substantial portion of his/her remaining stock to other shareholders (and attribution not be a meaningful factor). As a practical matter, therefore, capital gains treatment normally requires retirement or a bootstrap-acquisition "meaningful" shift of interest. Or under Sections 302(b)(4) and 302(e) (old Section 346) the transaction must qualify as a partial liquidation, a contraction of the S corporation's business at the corporate level. Such a transaction usually is practical only in services corporations (which historically have not been structured in the S mold).

If redemption status is obtained, then the entire amount paid for the stock (absent time value of money considerations) is treated as received in a sale or exchange even if economically attributable to inside accounts receivable. Thus, the S corporation entity approach redemption rules parallel the partnership entity approach sale or exchange to other shareholders or liquidation with unstated good will as to the selling owner. Indeed, more ordinary income is likely to be recognized under the collapsible partnership rules than will be recognized in the redemption of S corporation stock.

If the S corporation is carrying on a continuing business, and particularly if it has in the past been distributing rather than retaining profits, redemption of a substantial stock interest usually will require a "credit redemption". S corporation notes given in redemption of the retiring shareholder's stock should not pose a disqualifying "second class of stock" problem, so long as the minimal "straight debt safe harbor" requirements of Section 1361(c)(5) are met. For other purposes, however, such debt can still constitute disguised equity. At the present time the only applicable "standards" are to be found in the common-law morass. It appears, however, that treatment of redemption notes as debt is judged more lightly than the traditional debt equity criteria might suggest.

Much more difficult in the S corporation context is obtaining parallel treatment to unstated good will and Section 751(c) assets, principally unrealized receivables, than in the parallel partnership context. Most commentators suggest that the most likely avenue of success is the "severance pay" technique. Under this approach a retiring S corporation shareholder, particularly in a services corporation, is awarded severance pay upon retirement or other termination of interest, generally equal to his/her "pro rata share" of accounts receivable. While outside such severance pay is indeed likely to result in ordinary income to the retiring shareholder, the inside "reasonable compensation" deduction is more questionable. Under traditional corporate rules, such severance pay would be deductible only to the extent that it, plus prior compensation, did not exceed "unreasonable compensation". Depending on how the retiring S corporation shareholder was treated as to in-place accounts receivable upon his/her entry into the S corporation, the prior compensation from the S corporation is likely to have
been reasonable (particularly if shares of profit in the S corporation are taken into account). If this be the case, then additional severance pay is not deductible by the S corporation, i.e., it is passed through to the remaining S corporation shareholders.

b. Inside S Corporation Level Treatment

The inside S corporation treatment of a redemption poses no income tax problems to the S corporation so long as an in kind distribution is not involved. If, however, a redemption involves an in kind distribution, then, under the Section 1371 "incorporated" general corporate rules, the distributee shareholder presumably obtains an outside fair market value basis. The corporate rules are silent as to basis of property acquired in a redemption; therefore, under conventional wisdom Section 1012 applies to provide fair market value. However, this rule is not a subchapter C rule. So it may be doubtful whether Section 1371 incorporates it. However, so long as Section 1363(d) mandates inside recognition of distribution of appreciated property in redemptions and partial liquidations (and under the 1986 Code complete liquidations as well), then equity demands an outside fair market value basis step up. As discussed above, the better S corporation "flow through"-aggregate approach would have been a substituted basis, carryover taint and nonrecognition.

3. Conclusion

Maximum flexibility would grant owners the choice whether to treat continuing payments to a retired partner or S corporation shareholder on an "aggregate" or an "entity" approach. If an aggregate approach were chosen, then continuing payments would be treated as a distributive profit share or a guaranteed payment, turning on whether tied into the entity's profits or risk of payment. If an entity approach were chosen, then sale or exchange treatment and installment reporting of the owner's interest in the entity would be available.

In the partnership context, essentially just such choices are available. But in the S corporation context, the entity approach prevails. In order to receive the S corporation equivalent of a continuing profit share, an S corporation shareholder must retain a stock interest generating such "pro rata" share. Moreover, the other active S corporation shareholder's services must be adequately compensated in a family group. (The corresponding partnership provisions apply to all partnerships.) A risky, rough equivalent to a "guaranteed payment" in an S corporation context is perhaps obtainable through "severance pay". However, if prior compensation plus the severance pay exceeds reasonable compensation, then no deduction is allowable to the S corporation—a likely event if all the S corporation income has been passed thru to its shareholders.
L. Qualified Retirement Plans and Fringe Benefits

1. Subchapter K

a. Qualified Retirement Plans

Until 1982 substantial disparity existed between (1) corporate retirement plans and (2) retirement plans of partnerships or sole proprietors, principally as to substantially lower contribution and benefit ceilings in the case of the latter, but a host of other restrictions applied only to partnerships or sole proprietors as to vesting, coverage, distributions, self-dealing, etc. The qualified retirement plan of an S corporation was treated essentially as a corporate plan with partnership-like restrictions as to deductible contributions and self-dealing. In 1982 Congress separated the deduction rules and the abuse rules. True parity was achieved as to the level of tax incentives by raising H.R. 10 ceilings substantially while lowering corporate ceilings to the new H.R. 10 level under the rationale "that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend on whether the employer is an incorporated or unincorporated enterprise." At the same time Congress believed that the anti-abuse rules "should generally apply without regard to whether the employer maintaining the plan is incorporated or unincorporated." Thus, Congress imposed special restrictions (1) limiting the amount of a participant's compensation that can be taken into account in determining benefits, (2) requiring more rapid vesting, (3) providing minimum non-integrated contributions or benefits for non-key employee-participants, (4) reducing the Section 415 aggregate limitation on contributions and benefits for certain key employees, and (5) placing additional restrictions on distributions to key employees on "top-heavy plans" (i.e., plans which primarily benefit an employer's key employees), regardless of whether the plan is a corporate or partnership (sole proprietor) plan. These top-heavy rules are reminiscent of H.R. 10 restrictions, but not as rigorous. To a large degree, at least as to vesting, here too the 1986 Code with its more rigorous vesting requirements (5-year cliff or 3-7 year graded (20% a year)) for all plans, revised Section 411(a)(2), when effective in plan years beginning after 1988, Pub. L. 99-514, Title XI, § 1113(c)(1), largely, but not completely, catches up with Section 416(b)'s 3-year cliff or 6 years graded vesting.

There remained a small gap between corporate and partnership/subchapter S qualified retirement plans as to loans to participants. The tax amendments permitted such loans, but the labor provisions of ERISA were not amended. Thus, a distribution to a partner or shareholder-employee including a plan loan constituted a violation of Title I of ERISA. The 1986 Code made changes to the treatment of loans to participants, but while noting the ERISA conflict did nothing to resolve it. Furthermore, the new vesting and participation rules applicable to all plans, partnership or corporate, lessen the gap between top-heavy plans and non-top-heavy plans.

b. Fringe Benefits

Perusal of the major non-qualified retirement plan fringe benefit provisions in the Code reveals three major patterns: (1) explicit exclusion by cross reference to Section 401(c) of "self-employed individuals", including
partners, from eligible employees, Sections 101(b), 105(g), 127; (2) equally prevalent, application of one of various statutory anti-discrimination standards to preclude discriminatory benefits in favor of highly compensated employees, Sections 79, 125, and 132(h), surely more responsive to the underlying policies, if any; and (3) most rarely, simply silence. I.R.C. § 119.

Section 401(c) treats partners and other self-employed individuals as employees, by its own terms, only for purposes of Section 401, i.e., the basic qualification provision setting definitional requirements for a "qualified retirement plan." Therefore, exclusion in the other fringe benefits of self-employed individuals "described" in Section 401(c)(1) implies that a partner can achieve employee status other than through Section 401(c), thereby enhancing the precedential value of Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968). At the same time, the first category of fringe benefit provisions clearly bars availability of the particular fringe benefit to a partner even if he/she does attain employee status under Armstrong v. Phinney or any other rationale. But the other silent or anti-discrimination oriented fringe benefit provisions still may be available to a partner who also merits employee status.

Armstrong v. Phinney read the 1954-1984 predecessor to Section 707(a)(1) as adopting the "entity" approach where a partner not acting in his capacity as a partner sells to, purchases from, or renders services to, the partnership. In such circumstances, a partner can stand in any number of relationships with a partnership, including employee-employer for purposes in the case at bar in Armstrong v. Phinney, of Section 119 (which excludes from an employee's income "meals and lodging" furnished for the convenience for his/her employer). Consistent with Armstrong v. Phinney the Tax Court in Pratt established the converse rule. Partnership payments to a partner for performing services (a) within the normal scope of his duties as a general partner and (b) pursuant to the partnership agreement, cannot constitute Section 707(a)(1) payments because they fail the test of being paid for "not acting in capacity as partners". Thus, the touchstone for employee status for a partner is rendition of services other than within the normal scope of a general partner's duties and perhaps such services cannot be regular or continuous, unless customarily rendered by the partner to others for compensation (under a possible gloss added by Rev. Rul. 81-301).

A "guaranteed payment" under Section 707(c) constitutes a payment fixed without regard for partnership profits paid to a partner for services performed his/her capacity as a partner or for use of his/her capital—both such services and such use of capital without payment are the more usual form of partnership structure. Thus, the essence of Section 707(c) is that the partner is a non-partner only as to risk of payment. The activities or the use of capital constitute normal partner activities or investment. Consequently, not surprisingly the Section 707 regulations properly state that a guaranteed payment is a non-partner transaction only for purposes of Sections 61 and 162 (or Section 263). On the one hand the payment is not treated as a profit/share for purposes of the "varying interest" rule of Section 706(d)(3); the related party sale-loss disallowance rule of Section 707(b), which disallows recognition of a built-in loss upon a sale between a partnership and a partner who owns more than 50% of the profits interest (or capital interest); and the termination rule of Section 708(b) turning on a sale or exchange of 50% or more of the total interest in partnership profits (and
capital) during a 12-month period. On the other hand, a guaranteed payment is treated as a "distributive share" for other purposes, including most significantly timing, i.e., a guaranteed payment is included just as a distributive share is in the partner's tax year coinciding with the partnership tax year or in which the partnership tax year ends. In summary, a guaranteed payment does not, and should not, give rise to employee status, because the rendition of services—allowance of use of capital are partner-capacity transactions.

On its surface new Section 707(a)(2)(A) would appear to support and Armstrong v. Phinney non-partner capacity—employee status argument as to a partner receiving "disguised" payments (allocation-cum-distribution) for services. The 1984 amendment treats as a Section 707(a)(1) non-partner capacity transaction the (1) performance of services and transfer of property, viewed together with (2) an allocation and distribution if they are "properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership . .. ." The legislative history articulates the test as whether the services/property transfers plus allocation and distribution constitute the "substantively economic effect of direct payments" for such services/property. Congress clearly was directing new Section 707(a)(2)(A) at devices (one time or continuing) designed to avoid the capitalization (Section 263) or even the nonamortization requirements (Section 709) applicable to direct payments. S. Print No. 169, supra at 226; Tax Shelter Hearings, supra at 9-10, 22 (Ass't Sec'y Chapoton). The Senate Finance Committee "mandated" a six factor—facts and circumstances—test aimed primarily at lack of "entrepreneurial risk" as to amount and fact of payment, evidenced by factors such as certainty of payment, transitory nature of allocation, size of proportioned allocation in relationship to continuing interest in profits/losses. Id. at 227. If such payments, for example, a gross income allocation, are attributable to year-by-year continuing partnership capacity services, the deemed-non-partner capacity payments may in fact be much more like Section 707(c) guaranteed payments to a partner. Such payments, even though recharacterized as a non-partner capacity payment, perhaps should not give rise to employee status on a policy standpoint. However, the statute forces the payments into the non-partner capacity posture under Section 707(a)(1). The apparent rationale is "that to be considered partners for tax purposes, persons must, among other things, pool their assets and labor for the joint production of profit. To the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive, and the partner is acting as a third party." Joint Committee Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 2d Sess. 226 (1984). This test appears derived from the Court's test in Tower-Culbertson. Significantly, this is an "aggregate" definition. See Anderson & Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (First Installment), 15 Tax L. Rev. 285, 286-87 (1960).

The House provision in 1984 for disguised payments to partners for property or services would simply have treated the transaction as "a sale of property" to the partnership. The House anticipated that regulations would coordinate the new provision with existing rules regarding payments to partners in their non-partner capacity and guaranteed payments to partners,
as well as other provisions. The Senate Bill, without explanation, adopted the
deemed non-partner capacity approach followed in the final legislation.
While possibly Congress may have chosen the 707(a)(1) constructive
transaction rather than the Section 707(c) guaranteed payment approach due
to the timing differences, more likely following the logic that a partner must
not only contribute services or investment but also share in the risk as to
payment Congress considered such a service provider as not constituting a
partner unless from other aspects of the partnership. Indeed the legislative
history provides that the future regulations will determine whether such a
service provider is a partner. S. Print No. 169, supra at 227.

2. Subchapter S
   a. Qualified Retirement Plan

      From 1969 to 1982 qualified retirement plans maintained by S
corporations were treated as corporate retirement plans but subject only to a
few H.R. 10 like restrictions, principally as to deductible contributions for
shareholder-employees, allocations of forfeitures to such employees from
other such participants' accounts, and self dealing, but not to the balance of
the H.R. 10 restrictions on owner employees. This hybrid treatment ended
with TEFRA in 1982 and parity has been obtained, at least between qualified
retirement plans of partnerships and S corporations.

   b. Fringe Benefit Rule

      The standard exclusion, if any, from statutory fringe benefit provisions
for "self-employed individuals" under Section 401(c) does not encompass
shareholder-employees of S corporations. Thus, until 1982 standard corporate
fringe benefits were available for shareholder-employees just as for other
employees. However, TEFRA also added Section 1372, which provides that
for purposes of "employee fringe benefits," an S corporation is treated as a
partnership and a two percent or more S corporation shareholder is treated as
a partner. The legislative history is silent as to the S corporation treatment
of a shareholder-employee who receives a salary from the S corporation.

      The issue is whether receipt by an S corporation shareholder of a
"salary" is more like a "guaranteed payment" to a partner acting in his
capacity as such or is more like a direct payment to a non-partner for non-
partner capacity services, in which latter case alone could employee status
for fringe benefit purposes apply. A fundamental problem is that an S
corporation is an entity and under general corporate law a shareholder has no
duty to provide capital or services or be at risk as to return. Therefore,
seemingly if the shareholder provides services for compensation to the S
corporation it is in a non-shareholder capacity so that an employee status
could attach. Instead, the regulation should take a functional approach to
achieve the same result as a partnership, especially under the "emerging"
partnership approach where there is no risk, partner status does not attach.
In any event, regulations under Section 1372 should address the Section
707(a)(1), and in particular deemed payments for services in non-partner
capacity, and Section 707(c) guaranteed payment aspects of payments to
shareholders for services.
3. Conclusion

Conventional wisdom believed that after 1982 there was no longer any substantial difference between the tax treatment of partnerships and of S corporations as to qualified retirement plans and other statutory and nonstatutory fringe benefits. True, some obscure differences remain between the qualified retirement plans of a C corporation, including a closely held C corporation, and the qualified retirement plans of a partnership or an S corporation, particularly as to loans by qualified retirement plan trust to employees. This poses a "hidden" transactional cost to C to S conversions. But in this context partners and shareholder-employees of S corporations were treated the same in any event such loans to partners or shareholder-employees are now precluded by the Tax Reform Act of 1986.

The picture is less clear as to fringe benefits for partner-employees and subchapter S shareholder-employees. On the partnership side, certainty centered on the Section 707 amendments to non-partner capacity transactions and the continued vitality of Armstrong v. Phinney as well as its meaning. The S corporation difficulties arise from implementation of the Section 1372 mandate to treat an S corporation as a partnership and any two percent shareholder as a partner for purposes of employee fringe benefits of the Code. In particular, how does the teaching of Armstrong v. Phinney translate into an S corporation context, where the shareholder-employee receives a substantial salary for services?

III. NONTAX DIFFERENCES BETWEEN PASS-THRU ENTITIES.

A. Certainty of Legal Environment

1. Interpretive Materials.

The general environment governing rights of stockholders, management, and corporations vis-à-vis each other is much better established in statute, commentary, and precedents than the comparable partnership questions. Thus, the advisor can easier predict the consequences of the (S) corporate form than of the partnership form. Moreover, for good or for bad, corporate practice is developed to the extent that by-laws and articles of incorporation are extremely standard, with relatively small usually insignificant changes for each corporation. The buy-sell agreement should reflect more flexibility between the parties, but hereto often the approach is too cut and dried.

In contrast, drafting a good partnership agreement requires so many more questions of governance, distributions, treatment upon liquidation, etc. to be addressed, particularly where the partners have flexibility, that the drafting itself is more time consuming and expensive. The consulting time also is generally greater, and the consequences of planning are less certain.

The corporate advantage here may be slightly offset by the factor that most local jurisdictions have not addressed whether there should be different treatment under local law vis-a-vis shareholder rights for example in S corporations than are regular corporations. For example, frequently in closely held C corporations the majority can freeze out a minority, for example a widow, by not paying any dividends. In a tax arena in which earnings are currently taxed to the shareholders, a failure to distribute
previously taxed earnings may pose different fiduciary and equitable rules if judges are properly apprised of the differences.

2. **Certainty of Status.**

   If a general partnership is chosen as the tax entity, certainty is easiest obtained. The garden variety partnership organized under the Uniform Partnership Act easily constitutes a partnership under the association regulations. True, use of a limited partnership always poses status problems. But, the usual small business operating under subchapter K is usually conducted in the general partnership form. This is because while a limited partnership provides limitation against liabilities for a limited partner, such shield is lost if the limited partner takes an active role in the business. Banoff, *Tax Distinctions Between Limited and General Partners: An Operational Approach*, 35 Tax L. Rev. 1 (1979). Usually in the small business all the investor-entrepreneurs do take an active role. As a practical matter, therefore, limited partnership is not a feasible alternative.

   Status of C corporation is relatively easy to obtain and the formalities are easy to meet. As long as a formally organized C corporation is formed for, or serves, a business purpose it is treated as a corporation. *Pass-Through Entities Hearings*, supra at 28. But election of Subchapter S status properly is quite a different story. Eustice & Kuntz, *supra* at 2-10. The litigation record would show that more mistakes are made in S elections than in status and other areas. Hence, certainty of status is least likely to be obtained in the Subchapter S arena. This compounded by the fact that the Service only notifies the taxpayer that the S election has been received, not that S status has been obtained.

   Commentators often view the issue of the tax status of an entity, i.e., whether it constitutes a conduit or a separate tax entity, as posing a greater problem in the partnership context than in the S Corporation context due to the "association taxable as a corporation" risk as to a partnership but not as to an S Corporation. In reality, the "association" issue has been largely limited to limited partnerships in the tax shelter context. As the PAL becomes fully applicable this issue should be of far less importance in that context. However, the potential trend towards Master Limited Partnerships (MLP) and disincorporation may change this. But a moderately profitable business faces neither the shelter nor the MLP problems. To such enterprises the greater problem would appear to be the stock ownership and other eligibility requirements of an S Corporation, as well as the election process itself.

B. **Limitation of Liability.**

1. **Introduction.**

   The conventional wisdom is that an S corporation provides a corporate "shield" to protect the shareholder from liabilities of the corporation. In contrast, general partners have joint and several liability, except where excalpation clauses are obtained. While a limited partner may achieve limited liability except for unpaid capital contributions, a limited partnership is usually an inappropriate vehicle for conducting any small business in which all of the principles wish to take a part. Consequently, the shareholder's
limited liability is often the only substantial non-tax reason for choosing the corporate form for conducting a small business. See, e.g., Comment, Incorporated Lawyers—The Veil Rises and Falls, 55 U. Cinn. L. Rev. 785 (1987).

2. Exceptions to Limitation of Liability.

The corporate veil, however, has a number of tears in it. First, under the professional corporation laws of most jurisdictions the professional relationship is explicitly maintained together with unlimited personal liability for the professional rendering services. See, id. at 786. But, the states very widely as to how far the liability of an incorporated professional extends beyond his/her own acts.

Beyond the special professional corporation rules, the corporate veil can "pierced" for a variety of reasons, probably impossible to reconcile. More objectively, unpaid stock subscriptions trigger liability to that extent. Furthermore, a shareholder who also is a chief employee may be responsible for his/her own torts in the scope of his/her employment and possibly in supervising others. See Kessler & Yorio, supra 1 Corp. L. Rev. 291, 302-04.

Significant creditors, particularly third party lenders, usually require a guarantee by the shareholder and his/her spouse. Pass-Through Entities Hearings, supra at 19 (Mentz); Kessler & Richmond, supra, 7 Corp. L. Rev. at 294. For subchapter S tax reasons is highly inadvisable in the first place. Hence, borrowings in most S corporations will be at the shareholder level.

Finally, corporate assets are always subject to the liabilities of the corporation and particularly in the case of professional corporations unpaid accounts receivable may constitute a substantial asset equal at least to several month's earnings and in some businesses even a year's earnings. In summation, Treasury acknowledges that a close C "may more closely resemble a sole proprietorship than a corporation." Pass-Through Entities Hearings, supra at 28.

Turning to partnerships, joint and several liability exist as a matter of state law as to general partners. The only protection here is insurance and the right to contribution once a partner is required to pay more than his loss percentage of the obligation against the other general partners. If the partnership is unable to make the payments, the likelihood is that the other general partners are unable as well.

Limited partnership status does provide a shield except for unpaid capital contributions. However, the limited partners as a practical matter must give up control and participation in the business. See 1986 Bluebook supra at 214. Furthermore, if corporate general partners are involved, Rev. Proc. 72-13 and similar requirements must be met, raising again the uncertainty level.

C. Liquidity of Investment

Here the concept is whether the owner can withdraw his/her investment, or better "tax cost" or basis, from the pass-thru entity tax free. As discussed above such withdrawal is a standard feature of the pass-thru regime. Thus in a
partnership it is simple, provided that no disproportionate distribution consequences attach, as is likely to be the case unless proper precautions are taken, for the partner to withdraw his/her tax cost tax free under Section 731, particularly if cash distributions are involved. The same pattern prevails in the S corporation context only if there is no C E&P present. If there is, then the complicated AAA concept kicks in. See Coven, supra, 42 Tax L. Rev. at 394-401. The reality then is except as to S's that are converted C's, the partner's/shareholder's investment is equally liquid.

The real difference is between a C corporation and a pass-thru entity. The inability to withdraw C earnings without triggering an outside, generally ordinary income, tax to the shareholders can be both a blessing and curse. This is because either for business expansion reasons or for typically patriarchal family reasons, the corporation or the shareholders may not wish for minority shareholders to have the ability to freely withdraw the entity's earnings. In a pass-thru regime, the temptation to withdraw the earnings by minority partners or shareholders is well nigh irresistible. Thus, where the corporation, its management, or majority shareholders desire to lock in earnings and plow them back into expansion, then a C corporation is the preferred even if the corporate rates may approach or exceed the outside individual rates. See Passthrough Entities Hearings, supra at 26, 75 and 109 (Mentz, McKee, and Pennell). Indeed, this attitude by corporate managers in particular scuttled Treasury's 1977 partnership-like full integration proposal.

D. Rewarding Key Employees

Conventional wisdom is that a corporation (C or S) constitutes a better vehicle for rewarding key employees, through stock options. Without capital gains, qualified stock options lose their meager luster remaining. Non-qualified stock options are more likely to be the mechanism of reward. The bargain element will be ordinary income, but also create a deduction to the employer.

The flexibility, however, of profit shares, in my eyes renders the partnership in fact a better vehicle for compensation than a corporation. Moreover as discussed above a partnership can be used to give an interest for future services without immediate income taxation under the better view, whereas a corporation including a S corporation cannot be so used due to the entity approach embodied in Section 351(d).

E. Available Sources of Financing.

In theory the C corporation is most flexible as to the form of equity participation, permitting various classes of stock, voting and nonvoting, preferred, and various types of debt instruments, including securities or short term boot. The S corporation is considerably less flexible in theory due to the restrictions on number of owners, the restriction against non-individual owners, and the second class of stock requirement. These ownership restrictions (other than the shareholder cap to avoid "disincorporation" revenue drain) have been uniformly and ably criticized. See, e.g., Passthrough Entities Hearings, supra at 44, 60, 64-65 (Kuller, Robinovitz); Coven & Hess, supra at 575-92; Eustice, supra at 356-57, 397-400. In reality, however, most small corporations cannot raise equity money beyond the credit of a handful of the principals. Kessler & Yorio, supra at 299. Therefore the S corporation restrictions on classes of shareholder and stock have little impact. True, as the venture becomes much larger, it may seek to call upon equity capital that would not be available in an S corporation, e.g., a tax exempt
corporation or a tax exempt trust (for example, a qualified retirement plan trust) may be a ready source of capital in certain venture markets. This would unavailable to an S corporation.

Partnerships permit maximum flexibility as to type of investment, but the exposure in other than limited partnerships to liabilities renders them unattractive as investment vehicles for active businesses. Passthrough Entities Hearings, supra at 43 (McKee).

F. Continuity of Life

With this factor, we begin a series of pseudo-factors, i.e., factors that in conventional wisdom make a difference but in practicality operate functionally much the same in both pass-thru entities. Ironically they are factors that are used to distinguish corporations from partnerships under the association regs. See Passthrough Entities Hearings, supra at 26; Pass-Through Entities Hearing Pamphlet, supra at 4-7, 14. Indeed, industry witnesses at the Pass-Through Entity Hearings argued that these factors failed to distinguish between close C corporations and small partnerships. Passthrough Entities Hearings, supra at 51 (McKee).

As to continuity of life, in theory a corporation has indefinite life under most state corporate charter statutes. But as a practical matter when the principal dies the business dies too unless successors have already been arranged. Thus, what is important to the investor is less continuity and more the factor of transferability. See Kessler & Yorio, supra at 298.

In the S corporation context the additional wrinkle is added in that shareholders holding more than one-half of the shares of stock of an S corporation may terminate the S corporation by consent to revocation of the election. I.R.C. § 1362(d)(1)(B). Thus, more important than the corporate charter, is a restriction on revocation by the majority and upon transfer of a majority shares to someone who would revoke.

Noncontinuity in a partnership context arises from two sources. First, most of the Uniform Partnership Act requires a statement of how long the venture is to last and typically a 20 or 30 year term is selected. Furthermore, under the Uniform Partnership Act trigger events as to a general partner result in "disillusion" under state law, e.g., death, insanity, etc. of a general partner. However, by agreement the remaining partners may substitute a new general partner and continue the partnership. This could cause "status" problems. Pass-Through Entities Hearing Pamphlet, supra at 16.

For tax purposes a partnership "terminates" if no part of its business, financial operation, or venture continues to be carried on by any of its partners in a partnership or within a 12-month period there is a sale or exchange of 50% or more of the total interest in (a) partnership capital and (b) profits. I.R.C. § 708(b). Thus, a more than 50% shift in ownership (through purchase, but not through capital contribution) in both profits and capital will terminate the partnership for tax purposes. Treas. Reg. § 1.708-1(b)(1)(iv) provides essentially that the old partners and the new partners are deemed to have received a distribution from the old partnership, followed by a recontribution to the continuing partnership. The net effect of this is to provide a stepped up inside basis as to the new partner's interest even if no Section 754 election is in effect.
Such constructive distribution and recontribution trigger under the capital account rules generally a revaluation and capital account restatement. Treas. Reg. § 1.704-2(b)(2)(iv). By and large, however, the net effect absent disproportionate distributions, etc., as to the old partners of the entire transaction is zero. Private rulings apparently go the next step and treat the termination recontribution as an "entity" continuation contrary to the underlying aggregate policy. The entire rule has been criticized, Passthrough Entities Hearings, supra at 62-63 (Rabinovitz), but under an aggregate approach some percentage line drawing is necessary.

G. Transferability of Interest

In theory corporate shares under the Model Business Code are freely assignable. The reality, however, is that in most close corporations transfer is restricted by private contract, i.e., a buy-sell. See Kessler & Yorio, supra at 298-99. The other shareholders and the corporation are protected against unwanted newcomers by a right of first refusal and occasionally a call at a stated value or fair market value. At the same time, the shareholder or more precisely his/her estate or surviving spouse are protected by having a put to the corporation or the other shareholders under the buy-sell as well. This provides a market and prevents squeeze outs of estate and other heirs. Cf. Passthrough Entities Hearings, supra at 81. Such buy-sell is often funded by life insurance which leads to a necessity for careful planning as to the valuation formula. The ownership of shares in professional corporations is often restricted to licensed professionals under the state statute. Furthermore, ownership restrictions in a buy-sell are important in an S corporation context to preclude transfers to non-permitted shareholders or that would exceed the permitted number of shareholders. Such restrictions would not create a second class of stock in most circumstances.

Under the Uniform Partnership Act a partnership interest cannot be transferred without the consent of all the partners. This merely provides a legal requirement for what is a practical requirement in most close corporation buy-sell agreements. Moreover, such restriction on transferability does not preclude a transfer to a new partner. A partner can assign without the consent of other partners his/her right to profits (and losses) and partnership distributions, which is effective to make the assignee a successor partner for tax purposes, albeit not for state law purposes, even if the other partners are not aware of the transfer. See Evans v. Comm'r, supra. A limited partnership interest is freely assignable under the Uniform Limited Partnership Act, but rarely is there a market for such interest. Moreover, the partnership agreement can restrict such assignability and frequently does at least in the form of a right or first refusal.

Limited partners frequently give the general partner a blank check power-of-attorney consenting to substitution and admission of new limited partners. However, rarely a put or call is provided as to partnership interest and indeed there is probably even a narrower market for a partnership interest than for close corporate stock.

In essence there is little difference as to the practicalities of transferability of S corporation stock and a partnership interest for tax purposes, although the market is narrower for the latter than the former.
H. **Centralized Management: Governance**

The corporate entity offers centralized management because "the business and affairs of the corporation are managed by the board of directors." Section 35 M.B.C.A. Such directors unless otherwise provided are elected by a majority of the shareholders and the board in turn appoints the officers of the corporation who manage the day-to-day affairs of the corporation. In widely held public corporations, the board of directors generally appoints professional management to operate the corporation resulting in a separation of management and control from ownership. This rarely the case in the close corporation where the shareholders, the board of directors, and the corporate officers are generally one and the same. At the same time when one of the original principals dies different problems arise, generally a squeeze out of the nonactive shareholder while the others draw out the earnings through compensation. Here, a buy-sell agreement is a must. True, there is more development here of the corporate rules regarding fiduciary obligations of the majority to the minority, but all and all this has amounted to little.

In a general partnership centralization is nonexistent, unless by agreement the partnership appoints an executive committee or a managing partner, as is likely to be the case in a large professional partnership. Section 18 (U.P.A.). Moreover, such vesting of management authority in one or more general partners does not relieve the other partners from personal liability arising from claims against the partnership. A limited partnership does offer centralized management since all management authority must rest under the agreement and in actuality with the general partner. If a limited partner chooses to become involved with the management affairs of the partnership, he/she may become personally liable to third parties for partnership liabilities. U.L.P.A. § 303(a). See generally, Banoff, supra.

IV. THE WINDS OF CHANGE: RECLASSIFICATION AND INTEGRATION.

A. **Introduction**

The two major pass-through entities, partnerships and S corporations, have left one small business era with the close of the 1954 Code -- close C corporations as inside tax shelters, S corporations for initial losses, and partnerships for tax shelters -- for a new era under the 1986 Code. Under the 1986 Code as it now stands, or will perhaps stand after transition rules, it should be clear that a pass-through regime, particularly of income, will be the ideal for all larger, close business and should be for smaller close C corporations as well. But pass-through probably will not be chosen in all cases where warranted.

Save for the non-tax advantage of limited liability, such as it is, in an S corporation, Subchapter K appears the more flexible regime. And this actual limitation-of-liability potential of an S corporation is often more than counterbalanced by the denial of basis for inside S corporation debt (save for the shareholder's own loan to it). Yet common advice has been to reach for the S corporation as the ideal.

In fact, the current state of both Subchapters K and S is sad. The current Subchapter S rules are deficient, operationally or conceptually as to (1) entity-level debt and outside basis, (2) shareholder eligibility limitations (except perhaps as a backdoor block against homemade integration), (3) capital structure
limitation (single class of stock), (4) some aspects of special allocations, (5) inside entity level adjustments to assets on transfers of unit of ownership, and (6) conversion rules. See generally, Eustice, supra, 39 Tax L. Rev. at 355; Coven & Hess, supra, 59 Tenn. L. Rev. at 576-77, 590, 649-50, 666-70, 674, 694-99; Coven, supra, 74 Calif. L. Rev. at 59-62; Coven, supra, 42 Tax L. Rev. 381, at 383. Coven generally calls for more of a conduit approach, more closely paralleling the Subchapter K regime. Eustice appears to vary more, provision by provision, generally favoring a conduit or pass-through approach. Industry witnesses at the Pass-Through Hearings often followed Eustice's paradigm. See Passthrough Entities Hearings, supra at 43, 63-64.

Conversely, Postelwaite, Dutton & Magette, supra, 75 Geo. L.J. 423, adopt an entity approach as to (1) all formation or "organizational" issues, Id. at 437; (2) determination of amount and character of income at entity level, with income and loss "passing-through," Id. at 438-39, but bottom-line netted in an entity approach, Id. at 440-41; (3) all disposition and liquidation payments on complete aggregate approach, Id. at 442; and (4) transfers by sale or death result in inside aggregate basis adjustments; Id. at 445.

The original Subchapter K rules with the initial goal of letting partners allocate their tax burden among themselves, with Treasury a mere stakeholder led sooner (§ 751(b)) or later (§§ 707(a)(2), 704(c) and Reg. § 1.704-1(b)) to increasingly complex, mechanized rules, "vastly more difficult to apply, increasing administrative burdens on taxpayers and the Internal Revenue Service. . . ." Passthrough Entities Hearings, supra at 13, 32 (Mentz); accord, Id. at 55-56 (Joel Rabinovitz).

The Treasury proposed approach to Subchapters K and S is essentially an entity approach, with limited conduit pass-through of income and losses on a strict per unit of ownership basis (with some flexibility for service partners). And the basis for this approach is end abuse under Treas. Reg. § 1.704-1(b)'s capital account analysis. At the same time, Treasury proposed to tax master limited partnerships on the basis of the relationship (i.e., passive investors) of the limited partners to the entity.

B. Entity Classification Standards.

1. Aggregate Concept and "Material Participation".

The aggregate core of the 1954 Code, Holiday Village Shopping Center v. United States, 5 Cl. Ct. at 570, has been seemingly muted as Subchapter K twisted and turned from the ALI proposal of aggregate/pass-through with optional entity features for simplicity, to the House's version of an entity approach for simplicity with limited elective aggregate features, to the final Senate and Conference hybrid of (a) aggregate as to allocations, contributions, distributions, liabilities, basis adjustments and retirement payments, (b) entity as to accounting, reporting and now audit with entity and optional (mandatory or elective) aggregate treatment as to sales and transfers of an interest in the entity and where the partner deals as an outsider with a partnership, and (c) aggregate wherever else it would be appropriate. See, Hearing Before the Senate Finance Committee on H.R. 83,000, the Internal Revenue Code of 1954, 83d Cong., 2d Sess. 459 (1954) (Section of Taxation, ABA); H.R. No. 2543, 83d Cong., 2d Sess. at 59. Nevertheless, the undercurrent is that the aggregate/pass-through approach
of the 1939 Code was continued, with entity reporting. Moreover, reading the
entire legislative history, it is clear the Congress felt that the aggregate
approach was (1) more equitable (albeit more complex) with more accurate
tax results, and (2) functionally equivalent to dealing with oneself, so that the
goal under the aggregate approach is to subject the partner "to the same tax
consequences which would be accorded an individual entrepreneur," if there
were no partnership. S. Rep. No. 92, 99, and Conf. Rep. 58; 1984 Bluebook
238, see Holiday Village Shopping Center, 773 F.2d 282. Thus, the aggregate
approach treats a partnership as a collection of individuals jointly owning the
partnership property rather than as an entity in which the partners only own
shares in the enterprise. Holiday Village Shopping Center, 5 Cl. Ct. 571.

In short, under the functional approach, the partnership is treated
merely as a convenient income-reporting vehicle and not as a means of
effecting major changes in the tax consequences to the individuals involved.
Lane, 46 So. Cal. L. Rev. at 259-60. This approach of testing an allocation by
functional equivalency to direct taxation of an entrepreneur finds support in
the recent cases as well. The Tax Court in Otey justified its §§ 721 and 731
tax-free (contribution-distribution) treatment of contributed property
followed by distribution of loan proceeds to the contributing partner in order
to equalize capital investments in part on an analysis of treatment of the
partner's borrowing as if there had been no partnership at all. 70 T.C. at
321. However, the use of the partnership form to result in greater tax
benefits than would be available in the case of direct ownership implicitly
violates the aggregate approach. See 773 F.2d at 282 citing 1984 Bluebook at
238.

Most commentators and quite recently the Treasury as well
traditionally formulate the issue as pass-through entity versus separate (i.e.,
separately taxable entity). However, under a deep structure analysis, the
only university valid functional distinction is between an aggregate approach
and a separate entity approach (not necessarily as a separate taxpayer). In
other words, the basic issue as to which the classification regulations and
authorities have been stabbing for many years really is whether the taxpayer
is entitled to an aggregate approach or a separate entity approach. Under the
aggregate approach the owner is treated as nearly as possible like an
individual entrepreneur apart from the partnership, ideally in virtually all
aspects except audit, reporting, and perhaps characterization of income. In
contrast, under the entity approach the taxpayer is not treated as having any
inside interest in the entity's assets. A pass-through in such an entity is
limited to pro rata share of income and loss and withdrawal of investment and
no more. This essentially is the current Subchapter S approach and the
preferred approach of Treasury as to Subchapter K as well. These traditional
classification criteria do not speak in any way to whether the entity should be
taxed separately or should pass through its income/loss and permit withdrawal
of investment. Whether an entity (as contrasted to an aggregate) should be
able to pass through income and loss poses different policy questions
discussed below.

The Morrissey multi-factor resemblance approach remains with us down
to this day in the current (1960) Kintner regulations, which, however, as has
been extensively discussed elsewhere, deliberately place several thumbs on
the scales intending to classify most partnerships as such, limited or general,
not as an association taxable as a corporation. This was done to preclude
professional associations from attaining corporate status and, hence, corporate retirement benefits -- a campaign lost on several other fronts. A major difference in emphasis between Morrissey and the Kintner regulations was that the former's resemblance test was supplanted by a preponderance test under which the association must have three out of four corporate characteristics in order to be classified as a corporation. Moreover, the characteristics tests themselves deliberately took a mechanical formal approach over a substance approach. But even these were not the most serious flaws in the multi-factor approach.

First, as several commentators and witnesses at various hearings have hinted or directly argued, most, if not all, of the traditional corporate advantages, and hence, characteristics are functionally, in fact usually, not available to a close corporation and its owners which constitute approximately 90 percent of all corporations. Conversely, by skilled drafting most of the corporate advantages can be obtained by entities that traditionally have been viewed as partnerships. Thirdly, until the ill-fated preponderance test was provided, certainty as to classification was virtually impossible. Most suggestions for a multi-factor approach still pose the same problem, unless the thumb on the scales is simply reversed to apply a preponderance test as to partnership status. But the most serious defect is that the resemblance-characteristics multi-factor approach has never been clearly directed at any underlying identifiable policy.

On the eve of the 1954 Code, most small businesses were conducted in partnerships or sole proprietorships, not in corporations. But due to various factors, particularly (a) the inside corporate minimum bracket being substantially lower than the maximum outside bracket, and (b) the availability of corporate retirement benefits prior to full parity of corporate and non-corporate retirement plans in 1982, small businesses and in particular professionals came to prefer a separate corporate entity, not for traditional corporate advantages, but instead solely for the tax advantages of the retirement plans or the inside shelter. Indeed, under the 1954 Code when individual rates were still truly progressive (at least in appearance), owners of closely held corporations (usually subject only to the minimum corporate rates) were on the average higher income taxpayers than owners of publicly-held corporations.

Commentators have advocated myriad changes to the multi-factor approach, generally settling on one factor as determinative, either limited liability or whether the owner's interests are publicly traded. For reasons discussed below, none of these proposals go to the heart of the distinction between an aggregate and an entity approach. The Joint Committee Staff has stated that the issue of whether an entity should be treated as a separate (taxable) entity should turn in large part on the relationship between the entity and its owners: "In particular, to the extent that an entity is viewed as acting separately from its owners, rather than merely as their agent or alter ego, an argument can be made that it should be treated as a separate taxable unit." Passthrough Entities Hearing Pamphlet, supra at 13.

I agree that the relationship of the owner to the entity is a basis for determining whether the entity is to be treated as a separate entity (whether separately taxable or as an entity-conduit with pass-through of the entity's income or loss and generally tax-free withdrawal of investment including
accumulated earnings, but all other features essentially following an entity approach). The Joint Committee Staff bottomed its "relationship to the entity" analysis on the rationale that if the entity acts separately it, not the owners, actually earns the entity's "income in a realistic and substantial economic sense. To the extent of such separate action, owners may not have full control either over the process of earning the income, or over the use and disposition of amounts earned that the entity retains." The Joint Committee Staff did a fair job of tying the traditional factors into this analysis, but in fact only "centralization of management," as reinterpreted by the Staff really goes to the heart of the issue.

"The existence of centralization of management suggests that owners of an entity may not, at least by reason of their ownership interests, guide the activities of the entity on a regular and continuous basis. The presence of centralized management suggests at least some separation between the activities of the entity and those of the owners, even though the management may be viewed, in some respects, as the agent of the owners. In particular, it can be argued that an owner not involved in managing the entity is not properly viewed, in a realistic and substantial economic sense, as the party responsible for earning the income of the entity.

Passthrough Entities Hearing Pamphlet, supra at 14-15.

Assistant Secretary Mentz' written statement at the 1986 Pass-Through Entity Hearings points the way to a proper deep structure analysis: "The tax and non-tax factors that make the limited partnerships an unwieldy vehicle for a publicly traded business enterprise all derived from the fact the partnership rules are, on the whole, designed to treat the partnership as an aggregation of its individual partners." Passthrough Entities Hearings, supra at 30.

Treasury too attempted to tie into this aggregate partners analysis its wish list for classification factors, requiring:

"corporate classification in the case of an entity that, one, has a large number of owners, substantially all of whom are not involved in the management or operation of the entity; two, has ownership interest that changed hands frequently; three, has access to capital markets in a manner comparable to large corporate entities; and, four, is carrying on significant business activity and dividing the gains therefrom."

Passthrough Entities Hearings, supra at 11.

Only the first factor corresponds exactly with the underlying policy. If substantially all of the owners are not involved in the management or operation of the entity, there is no functional basis for an aggregate approach. An entity approach is called for. It is conceivable, albeit unlikely, that an entity with a large number of owners and publicly traded ownership interests may have a large number of owners who are involved in the management or operation of the entity. Treasury surely added the frequently change of ownership and access to capital markets factors in order to narrow effectively the targeted group to master limited partnerships.
In fact, the functional aggregate analysis could readily use the new "material participation" standards as a starting point in determining whether the entity should be treated as an aggregate of its owners. The "material participation" standard also looks at the relationship of the owner to the activity of the entity. "The relationship to an activity of an investor who does not materially participate may be little different from the relationship of a shareholder to a corporation." S. Rep. No. 313, 99th Cong., 2d Sess. at 717. The actual approach probably should not track the detailed rule after detailed rule applied to passive activity losses. For example, the automatic rule excluding real estate from material participation except in narrow circumstances probably is inapplicable in this context. Conversely, limited partnership status, whether or not the interest is publicly traded, would functionally appear to be an interest that does not materially participate and hence would be limited to an entity approach. Moreover, following through logically, closely held C corporations that functionally would be aggregates should not be entitled to deferred taxation to the owner until distribution of profits. Treasury would avoid this little problem (encompassing probably 90 percent of all corporations) by granting automatic status to a general partnership and a formally organized corporation, in effect only applying the relationship to the entity analysis to limited partners, indeed, publicly traded limited partnerships or master limited partnerships. Is this really any different than the Kintner regulations -- result-oriented mechanical tests not responsive to the underlying policy?

Material participation for this purpose should not be limited to performance of services by the partner. In a small enough operation, for example, the classic moneyman and service partner, a general partner moneyman should be deemed to materially participate if he is a general partner.

Public trading of the ownership interest in the entity probably means as a practical matter that the majority of the owners of the entity do not materially participate and hence should be limited to an entity relationship. The same cannot be said about the other single classification factor currently advocated, namely limited liability. It is possible for an entity in which substantially all of the owners materially participate in the business to have nonrecourse financing, or more likely to not have any substantial debt, if a service organization, and to have insurance against all substantial risks (although that too becomes less likely under current insurance practices). Indeed Congress itself in PAL provisions recognized that liability and material participation were not synonymous. "The distinction that the Committee believes should be drawn between activities on the basis of material participation bears no relationship to the question of whether, and to what extent, the taxpayer is at risk with respect to the activities." S. Rep. No. 313, supra at 717. Moreover, the absence or presence of liability does not address the underlying aggregate issues. Compare id. at 717 n.6.


The above discussion posits that the only policy grounds for distinguishing "aggregate" treatment from "separate entity" treatment is "material participation" or investment by a general partner-moneyman in a small partnership. Industry witnesses at the Pass-Through Hearings argued that such a standard (or not publicly traded) actually would mean that most
close C corporations should not be treated as separate (tax) entity, but as a conduit. Passthrough Entities Hearings, supra at 43, 51, 81 (McKee; Barksdale Hortenstine). I agree -- close C corporations in which most of the owners materially participate should be required to report on a pass-through basis -- either (a) a modified Subchapter K model ("aggregate") or (b) a modified entity or Subchapter S model with flow through of income/loss, with no inside basis adjustments or special allocations, much like Treasury's preferred entity-conduit. As I have pointed out earlier, no policy basis exists for the graduated close C rates, as Treasury and the Staff know, see Lee, Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions From Overly Processed Corn Products, 30 Tax Notes 1375, 1384 n.39 (1986). Therefore, repeal of the graduate rate or a mandatory pass-through for close C corporations where most of the owners materially participate is dictated by tax policy. And Treasury's argument that "certainty" is best served by respecting close C corporations formed under state law appears a Kintner-like cop-out. But Congress has been told many times about use of a close C as an inside tax shelter. See, e.g., Hearings on President's 1978 Tax Reduction and Reform Proposals Before House Ways & Means Comm., 95th Cong., 2d Sess. (Part 8) 3517-19 (1978) (Dennis Gaffney); Panel Discussions on Income Tax Revision Before the House Comm. on Ways and Means, 86th Cong., 1st Sess. 903-04 (1959) (Janin); Compendium, 86th Cong., 1st Sess. at 1686 (Janin); Hearings on General Revenue Revision Before the House Ways & Means Comm., 83d Cong., 1st Sess. (Part 2) T166 (1954) (Colloquy Chairman and F.N. Barnes, a rancher). And where the owner controls the income as in close C's, the conduit principle should apply. 1978 Hearings, 95th Cong., 2d Sess.; Panel Discussions, 86th Cong., 1st Sess. at 905, 912; Tax Revision, Compendium, supra at 1688, 1695 (Janin).

Ideally, a close C would have three options: (1) liquidation and reformation as "aggregate," (2) remaining a corporation but being taxed under the "aggregate" provisions, the original 1954 idea of S, or (3) conduit pass-through under an entity-conduit or S-like model.

3. MLPs, publicly traded C's and integration.


For Treasury, master limited partnerships were to be taxed as separate entities because of the passive investment relationship of such limited partners/owners to the business. Taxation as a separate entity was automatic, because "integration" was not possible "as it involves competing considerations of economic theory, administrative practicality, fiscal responsibility, and public perceptions of fairness." Passthrough Entities Hearings, supra at 17, 25-26 (Mentz). Treasury's heart "obviously lay with classic integration" (or more likely dividends paid deduction, which I suspect actually magnifies the deferral).

As discussed above, the first question that must be addressed in considering the proper taxation of business enterprises is under what circumstances should an enterprise be treated as a taxable entity separate from its owners.

Most economists agree that income from business activities carried on through separate legal entities should not be
taxed more onerously than income from activities not conducted in entity form. This view is grounded in the proposition that a market economy operates most efficiently if all business activities are subject to the same rate of tax.

Under current law, significant differences in effective tax rates result from subjecting certain business activities to an extra level of tax. With minimum corporate and individual income tax rates of 46 and 50 percent, respectively, the current maximum effective tax rate on corporate earnings distributed to shareholders is, as noted above, 73 percent, nearly 1-1/2 times the maximum effective tax rate on income taxed only to individuals.

When you have this different kind of treatment, significant inefficiencies will result. That raises the question, is there a possibility of integrating the corporate shareholder system of taxation?

As a matter of ideal tax policy, income from different business activities should be taxed at equivalent rates, irrespective of the corporate and individual income tax systems will perpetuate differences in effective tax rates.

Such differences will exist not only among different entities engaging in the same activity, but among different sectors of the economy, with the production of those goods and services that are more readily produced by corporations discouraged relative to the production of other goods and services.

A wholesaler that is doing business in corporate form generally bears a higher burden of tax than a similarly situated wholesaler operating through a limited partnership.

Realistically, it does not appear that a significant level of integration will be achieved in the foreseeable future.

*Passthrough Entities Hearings, supra* at 10 (Mentz).

Ass't Sec'y Mentz continued that because MLPs functionally resembled publicly traded C corporations they too should be subject to § 11 C corporation tax, even though "horizontal equity" is violated. *Id.* at 11-11. As discussed blow, I believe horizontal equity together with vertical equity in fact require a similar burden of taxation on income earned by a large C and similarly by a separate entity with passive investors. However, entity-conduit treatment may still be available.

b. First, a little policy theory.

When Congress first imposed a separate corporate income tax in 1909 it provided no principled analysis as to the tax policy for imposing such a tax. Clark, *Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90, 97 (1977). The cause may have been that this income tax was initially de minimis. *Id.*
Historically, no doubt, the first rather nominal corporate income taxes were motivated by a combination of the desire to raise revenue and the realistic perception of corporations as legal entities which, independent of their shareholders, bought and sold, generated large amounts of revenue and income, and reported the results. It is no accident that corporate taxes began to appear just as industrial corporations first began to occupy major independent roles in the economy. The legalistic theory of a privilege or franchise tax would not justify the present 48 percent tax, which is out of proportion to the benefit conferred. On the other than, the demand for tax revenues has continued to increase through wars and growth in the size of government, and today corporations are larger, account for a substantial portion of the national income, and in many cases are so wisely held that few shareholders have more than a minute percentage of ownership.

1978 Hearings, supra at 3419 (Ernest Christian).

The recent reality has been, however, that 90 percent of the C corporations in existence do not operate independently of their shareholders and they, not the corporation, really earn the income, case law notwithstanding (which reflects probably proper deference to the legislature), and then should be taxed directly on the income whether or not it is distributed. See 1978 Hearings, supra at 3419. However, the 10 percent of the corporations which are publicly traded generate 90 percent of the taxable income reported and indeed three percent of these corporations report over 60 percent of the total income. 33 Tax Notes 292.

In addition to raising revenue, the other conceptual basis often offered for the corporate tax is to preserve the integrity of taxing individuals at progressive rates of tax. 1978 Hearings, supra at 3421; 5 Va. Tax Rev. 577, 583. Obviously this was not the original intent of Congress since there was no individual income tax when the corporate income tax was first imposed. Clark, 87 Yale L.J. at 97. Furthermore, a far more efficient means of backstopping the individual rates would have been a mandatory pass-through of the entity's income whether or not distributed. Moreover, as long as the maximum individual rate was considerably higher than the maximum corporate rate, many high bracket taxpayers used publicly traded C corporations (as well as closely held C corporations) as an inside tax shelter. While commentators have pointed out that as to a lower bracket individual taxpayer, the burden of double taxation is far greater and the C does not serve as an inside tax shelter, 1978 Hearings, supra at 3422, 6079, the reality is that low bracket taxpayers don't own corporate stock, 1978 Hearings, supra at 3504, 3507, 6104-05 (Sheldon Cohen).

Separate taxation of a separate entity fares no better under classic tax policy analysis. One of the "commonly accepted canons of taxation" is tax entity which rests on "ability-to-pay, horizontal and vertical equity, and the benefit principal." McCure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532, 535 (1975). Ability-to-pay and vertical equity speak to the relative tax burdens imposed on taxpayers at various points in income
distribution. Conceptually, therefore, the flat corporate tax is perceived as taxing the corporate source income of shareholders at a flat rate regardless of their marginal rates. Horizontal equity is defined as equal treatment of taxpayers with equal income, which arguably is violated since corporate source income when double taxation applies is higher than any other source income, as Mentz appears to believe. Passthrough Entities Hearings, supra at 10, 24-25.

The historical reality has been that as to publicly traded C corporations, the net inside and outside tax, until recent years, has been less than if the shareholder operated the enterprise directly, due to corporate retention of earnings taxed at lower than individual rates coupled with shareholder realization through capital gains rates or after date of death step up with no outside tax. Thus, integration should have been applied to large C corporations as well as under the 1954 Code to end inside shelter. See Sheppard, Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax, 27 Notes 37, 638-39 (1985). The further reality is that due to ever increasing 1976-86 tax shelters, capital gains preference and other preferences, the effective rate was actually not progressive, but regressive vis-a-vis the mythical middle income taxpayer. Thus, while the brackets may have stayed constant, see Cohen, Reflections on the U.S. Progressive Income Tax: Its Past and Present, 62 Va. L. Rev. 1317, 1331 (1976), the actual effective rate has dropped at the top. Haskell, 35 Tax Notes 301. Therefore, vertical equity was, and is, violated by the current individual income classes taken alone as to vertical distributional balance. But the incidence of corporate tax is believed to fall on shareholders in the short run and hence adds some progressivity to an otherwise regressive system.