PASS-THROUGH ENTITY TAXATION: A TEMPEST IN THE TAX REFORM TEAPOT

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Congress is considering fundamental business tax reform.[1] House Republicans believe that corporate tax rates should be 25%.[2] The White House and the Treasury Department have publicly supported a reduced 28% corporate tax rate,[3] but it

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1. Max Baucus & Dave Camp, *Tax Reform is Very Much Alive and Doable*, Op-Ed., WALL ST. J., Apr. 7, 2013, at A19 (joint article stating that over 50 hearings have been held and that both Congressmen are committed to a bi-partisan tax reform effort); Lindsey McPherson, *Baucus Says There's 'No Fallback' Option to Major Tax Code Overhaul*, TAX NOTES TODAY (Tax Analysts), Doc. 2013-8514 (Apr. 10, 2013), *available at* LEXIS 2013 TNT 69-2; Michael Gleeson & Lindsey McPherson, *Baucus Says He Will 'Double Down' on Tax Reform; Camp Says Reform More Likely*, TAX NOTES TODAY (Tax Analysts), Doc. 2013-10099 (Apr. 25, 2013), *available at* LEXIS 2013 TNT 80-1; Michael Gleeson & Lindsey McPherson, *Prospects for Tax Reform Unclear After Baucus Announces Retirement*, TAX NOTES TODAY (Tax Analysts), Doc. 2013-9920 (Apr. 23, 2013), *available at* LEXIS 2013 TNT 79-1 (quoting Senator Baucus as indicating that he will not seek re-election but that tax reform remains a key priority for him for his remaining term).

2. H. COMM. ON WAYS & MEANS, 112TH CONG., TAX REFORM ACT OF 2011 tit. II, § 201(a)(2)(B) (Discussion Draft 2011), http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf; H. COMM. ON WAYS & MEANS, 112TH CONG., TECHNICAL EXPLANATIONS OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME 1-2 (2011), http://waysandmeans.house.gov/uploadedfiles/final_te_—_ways_and_means_participation_exemption_discussion_draft.pdf.

3. *See* DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 9-10 (2012) [hereinafter PRESIDENT'S 2012 FRAMEWORK], http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf; *see also President's Economic Recovery Advisory Board (PERAB) Tax Reform Task Force Releases Final Report*, at 74-77, TAX NOTES TODAY (Tax Analysts), Doc. 2010-19068 (Aug. 27, 2010) [hereinafter

appears that the administration only supports corporate tax reform and is not supportive of efforts to reduce the top individual tax rate.[4] If this were all we had to consider, then one would think that the two political parties are not far apart in their objectives for fundamental business tax reform.

However, the devil is in the details, and one of the most devilish of details involves the question of what should be done about pass-through entity taxation. The Treasury Department,[5] the House Ways & Means Committee[6] and the staff of the Senate Finance Committee[7] have each issued their own options for small business tax reform. In addition to those proposals, some have called for the enactment of a broad-based business-entity tax that would apply to all forms of conducting business activities regardless of the tax classification of the particular business entity (whether C corporation, S corporation, partnership, or other pass-through entity).[8] Repeated attempts have been made in the past to seriously consider an integrated shareholder-corporation tax system.[9] In May 2011, the Treasury Department indicated that it was considering a proposal to tax all businesses

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President's Economic Recovery Advisory Board], *available at* LEXIS 2010 TNT 167-50.

4. *See The President's Fiscal Year 2014 Budget Before H. Comm. on the Budget*, 113th Cong. 6 (2013) (testimony of Jeff Zients, Acting Director, Office of Management and Budget).

5. *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 27-28 (2012), http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

6. H. COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2013 tit. II, §§ 211-23 (Discussion Draft 2013), http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_legislative_text_03.12.13.pdf; The House Committee on Ways and Means held a public hearing on March 7, 2012, entitled "The Treatment of Closely-Held Businesses in the Context of Tax Reform" where significant testimony was received from various constituencies. *Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform Before the H. Comm. on Ways & Means*, 112th Cong. (2012). For a discussion of the significant structural issues, see STAFF OF J. COMM. ON TAXATION, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY: SCHEDULED FOR A PUBLIC HEARING BEFORE THE H. COMM. ON WAYS & MEANS 69-70 (2012), https://www.jct.gov/publications.html?func=startdown&id=4402.;

7. STAFF OF S. FIN. COMM., 113th Cong., REP. ON BUSINESS INVESTMENT & INNOVATION (Comm. Print 2013).

8. Martin A. Sullivan, *Economic Analysis: Why Not Tax Large Pass-Throughs as Corporations?*, 131 TAX NOTES 1015 (2011) (being broadly consistent with the President's 2012 Framework).

9. *See* THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 129 (2005), http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_5-7.pdf; *President's Economic Recovery Advisory Board*, *supra* note 3, at 64-65; ALVIN C. WARREN, FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES AT 1 (1993); DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992).

with $50 million of revenue or more as C corporations.[10] Others have called for the outright repeal of the corporate income tax entirely for all nonpublicly traded entities.[11] Others have proposed variations of shareholder-corporate integration.[12] Others have argued for the tax deductibility of dividends.[13] Others have argued that there is no need for fundamental reform of pass-through entity taxation and that only simplification tweaks should be done.[14] There seems to be almost as many reform proposal variations as there are people who express an interest in this topic. And, given the broad differences of opinion, the press has reported that the inability to gain consensus on any one proposal for pass-through entity taxation represents a major sticking point in the broader business tax reform effort.[15]

The point of this article can be simply stated: lowering corporate tax rates to 28% while maintaining the top individual rate at 39.6%, and maintaining a tax rate on capital gains[16] and

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10. *See* Ryan J. Donmoyer, *Geithner Says Tax Overhaul Must Address Businesses Filing as Individuals* BLOOMBERG NEWS Feb. 25, 2011, http://www.bloomberg.com/news/2011-02-25/geithner-says-tax-overhaul-must-address-businesses-filing-as-individuals.html; *See also* Sullivan, *supra* note 8. *But see* Bradley T. Borden, *"Three Cheers for Passthrough Taxation,"* 131 TAX NOTES 1353 (2011) (stating that the proposal really means to shift the burden to smaller businesses).

11. GEORGE K. YIN & DAVID J. SHAKOW, FEDERAL INCOME TAX PROJECT; TAXATION OF PRIVATE BUSINESS ENTERPRISES 1 (Am. Law Inst. 1999); *see also* DEP'T OF THE TREASURY, *supra* note 9. Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1117-18 (2000).

12. *See, e.g.*, Joseph M. Dodge, *A Combined Mark-To-Market and Pass-Through Corporate-Shareholder Integration Proposal,* 50 TAX L. REV. 265, 266 (1995).

13. Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction 4* (U. of Mich. Law & Econ., Empirical Legal Stud. Ctr., Working Paper No. 10-028, 2010), *available at* http://ssrn.com/abstract=1680219.

14. *See* Robert R. Wootton, *Law School Rep Examines Ways and Means Discussion Draft on Passthroughs,* TAX NOTES TODAY (Tax Analysts), Doc. 2013-7758 (Apr. 2, 2013), *available at* LEXIS 2013 TNT 63-38; *see also* Jeffrey L. Kwall, *Law Professor Calls for Modifying Elective System for Closely Held Businesses,* TAX NOTES TODAY (Tax Analysts), Doc 2012-4834 (Mar. 7, 2012), *available at* LEXIS 2012 TNT 46-41; Rudolph R. Ramelli & Charles H. Egerton, *ABA Tax Section Suggests S Corporation Tax Reform Options,* TAX NOTES TODAY (Tax Analysts), Doc. 2013-8742 (Apr. 10, 2013), *available at* LEXIS 2013 TNT 70-45;

15. *See* Lydia Beyoud, *Passthroughs a Key Sticking Point For Tax Reform in 2013, Analyst Says,* 16 MERGERS & ACQUISITIONS L. REP. 103, (2013).

16. Some have argued for a substantial curtailment of the capital gains tax rate preference. *See* Calvin H. Johnson, *Fixing Capital Gains at the Core,* 125 TAX NOTES 1221, 1221 (2009), *available at* http://www.utexas.edu/law/faculty/calvinjohnson/fixing-capital-gains-12-14-2009.pdf. Regardless of whether a larger reform proposal included a removal of a capital gains preference, the equalization of capital gains rates with dividend rates calls into question the significant complexity that exists in Subchapter C that was implemented in an era where Congress wanted to prevent the bail-out of corporate earnings at capital gains rates. Now that dividends and capital gain rates are equalized, further simplification of Subchapter C can now be achieved by removing those provisions, but the analysis of how to simplify Subchapter C is beyond the scope of this paper.

qualified dividends at 20%, should cause a broad cross-section of closely-held businesses to decide on their own to exit their pass-through entity structures and to opt for reincorporating their businesses back into C corporation form.[17] The issue of how to harmonize pass-through entity taxation would become a side-show to the reality that small businesses would be exiting those structures in mass. The reason for this statement is that business tax reform that proceeds along the lines outlined above would return the country back to a tax rate paradigm similar to the one that existed prior to 1980.[18] In that paradigm before the fifth edition of Bittker & Eustice, growth-oriented small businesses as a general rule were incorporated into C corporations in order to avoid the relatively high individual tax rates.[19] If that is what Congress wants to focus on (small businesses that generate good-paying jobs),[20] then pass-through entity taxation is a regime built for the past era and not for the era of the tax rate paradigm being discussed by Congress. The beginning point of the analysis is set forth in **Illustration #1**.

> **Illustration #1:** A closely held business is conducted in a C corporation for federal tax purposes. Let's further assume that the highest corporate tax rate were reduced to 28% and individual rates remained at 39.6% for ordinary income and that a 20% tax rate applies to qualified dividends. Even though the majority shareholder is active in the C corporation's business, the 3.8% surtax in § 1411(a)(1) would apply to any qualified dividends distributed to the majority shareholder as a shareholder.[21] In this scenario, if all of the

17. The implication of this rate differential is discussed in more detail below. *See* discussion *infra* Parts I, II; however, the implication has not been lost on special interest groups representing the pass-through industry. *See, e.g.*, *The S Corporation Association Comments to the House Committee on Ways and Means Pass-through Business Working Group*, (Apr. 15, 2013), http://waysandmeans.house.gov/uploadedfiles/s_coporation_association_wg_comments.pdf (argues that individual and corporate tax rates should remain similar and should both be low).

18. *See* discussion *infra* Part I.A.

19. *See infra* note 26.

20. *See Ways and Means Small Business Tax Reform Discussion Draft: Hearing Before the H. Comm. on Ways and Means*, 113th Cong. (2013) (opening statement of H. Rep. Pat Tiberi), *available at* http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=333899.

21. *See* I.R.C. § 1411(a)(1), (c)(1)(A)(i) (2012) (dividends subject to surtax unless derived in ordinary course of trade or business). The trade or business exception set forth in I.R.C. § 1411 defaults to the standards set forth in I.R.C. § 469 for purposes of determining passive activities. *See* I.R.C. § 1411(c)(2) (2012). Under I.R.C. § 469,

after-tax corporate earnings were distributed on a current basis, the combined corporate and shareholder tax would be as follows:

Corporate Tax:	28.000%
Individual Tax (72% * 23.8%)	17.136%
All-In Tax Cost	45.136%

Thus, the above **Illustration #1** appears to augur against the thesis of this article because it demonstrates that the double-tax cost of conducting business through a C corporation is nominally more costly than conducting business in a pass-through entity structure that is subject to tax at only the top individual tax rate of 39.6%.

But, this assessment is short-sided because **Illustration #1** fails to consider time value of money principles. In this regard, the following **Illustration #2** represents a more relevant hypothetical to frame one's analysis:

> **Illustration #2:** Let's assume that the business owner in **Illustration #1** expects to earn a 12% return on her money and that the profits from the business would be reinvested back into the business for longer than four years. In that event, the deferral of the shareholder-level tax for four years would cause the net present value cost of the shareholder-level tax on qualified dividends to be reduced on a present value basis to 10.89 (i.e., $17.136 \div 1.12^4$). Thus, if the shareholder-level tax is deferred four years, then the all-in tax cost in present value terms of conducting business in a C corporation becomes as follows:

Corporate Tax:	28.00%
Individual Tax ($17.136\% \div 1.12^4$)	10.89%
All-In Tax Cost	38.89%

Thus, with only a four-year reinvestment of the corporate earnings and the corresponding deferral of the shareholder-level tax on qualified dividends for that same period, the C corporate "double tax" alternative is less expensive in present value terms

dividends from a closely held corporation are generally considered to be passive activity income and none of the exceptions to such a characterization contained in I.R.C. § 469 are generally applicable. *See* Treas. Reg. § 1.469-2T(c)(3)(i)(A) (2013) (provides that dividends on C corporation stock is generally portfolio income); Treas. Reg. § 1.469-2T(c)(3)(ii) (provides several exceptions that are not generally applicable).

versus the pass-through entity alternative where business profits are taxed only once at the top individual tax rate of 39.6%.

If the shareholder-level tax were deferred 20 years, then the present value cost of the shareholder-level tax would be reduced from 10.89 in **Illustration #2** to 1.78 (i.e., $17.136 \div 1.12^{20}$). If the shareholder-level tax were permanently avoided via estate planning strategies, then conducting a closely held business in a C corporation format would achieve a 28% tax rate on active business income, compared to a 39.6% tax rate for earning that same income in a pass-through entity structure. Furthermore, if a pass-through entity were incorporated as a C corporation in 2013 and met the requirements for a qualified small business stock within the meaning of § 1202(c), then § 1202(a) provides for up to a 100% exclusion of the capital gain realized by noncorporate shareholders on their sale of qualified small business stock.[22] The Treasury Department has proposed to make **permanent** § 1202's 100% exclusion for capital gains on qualified small business stock.[23] If § 1202 were amended so that it provided a **permanent** exclusion of 100% of the capital gain from the disposition of qualified small business stock, then an important pathway would be opened to broadly eliminate the shareholder-level tax for many closely held C corporations. Thus, these further variations indicate that the C corporate tax advantage in **Illustration #2** can be significantly enhanced, but even without such enhancements, the facts posited in **Illustration #2** make the point that many owners of growing closely held businesses would be faced with a paradigm shift: they should voluntarily leave pass-through entity structures and incorporate their businesses back into C corporate form if tax reform proceeds as currently envisioned. Once this conclusion is broadly understood, Congress need do nothing further with respect to pass-through entity taxation in order to minimize its ongoing significance.

To test this thesis, it is helpful to consider the impact that the Tax Reform Act of 1986 had on business planning for closely held businesses in America.[24] The choice of entity lessons learned from that earlier reform effort provides helpful insight for the current discussion and frames the critical policy choices raised by the pending paradigm shift.

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22. I.R.C. § 1202(a)(4), (b).

23. *See* DEP'T OF THE TREASURY 2013, *supra* note 5, at 37-38; *see also* STAFF OF S. FIN. COMM., *supra* note 7, at 7. For a contrary view on the advisability of capital gains preferences, see Johnson, *supra* note 16.

24. Tax Reform Act of 1986, H.R. 3838, 99th Cong. (1986) (enacted).

I. BACKGROUND

A. *Pre-1986 Law*

Prior to 1980, the top individual tax rate was 70% while the top corporate tax rate was 46%.[25] In this environment, as indicated in the leading treatise of the time, the vast majority of business owners decided to conduct their business activities in C corporation form.[26] Furthermore, when the business owner then faced the issue of needing to distribute appreciated assets out of corporate solution, the business owner could generally do so without bearing corporate-level taxation on the associated built-in gain under the law that existed prior to the repeal of the *General Utilities* doctrine.[27]

While the *General Utilities* doctrine generally protected corporations from incurring a tax upon a distribution of appreciated assets out of corporate solution (with certain exceptions),[28] the shareholders would recognize shareholder-level gain on the distribution equal to the excess of the fair market value of the distributed assets over the shareholder's stock basis.[29] When the shareholder later sold the distributed assets to

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25. For 1981 rates, see JOSEPH PECHMAN, FEDERAL TAX POLICY 303, tbl.A-1 (4th ed. 1985).

26. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.01 (3rd ed. 1969), which states as follows:

The disparity between the steeply graduated tax on the income of individuals and the more modest, relatively flat rate on corporations has for many years tempted taxpayers to use the corporation as a shield against individual income tax. . . . To be sure, the corporate after-tax income is not immediately available for personal consumption, but this may not be critical: the sole shareholder of the corporation may be satisfied to accumulate the income in the corporation for ultimate transfer at his death, to sell the stock (reporting the accumulated income as long-term capital gain), or to exchange it for the marketable stock of a publicly held corporation in a tax free merger. *See also* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.01 (4th ed. 1979) (contains same quote).

27. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200. (holding that a distribution of assets by a corporation to its shareholders did not constitute a sale or exchange of the distributed assets and accordingly the distributing corporation did not incur a taxable gain or loss from the distribution). The *General Utilities* doctrine, as it came to be known, was codified in the Internal Revenue Code of 1954 in old Section 311(a)(2) as to non-liquidating distributions and in old Section 336 with respect to liquidating distributions. *See* BITTKER & EUSTICE, *supra* note 26, ¶ 8.20 (7th ed. 2006 with updates through August 2011); *see also* H.R. REP. NO. 99-841, at 198 (1986).

28. For a summary of the pre-1986 law on corporate distributions of appreciated property and the various exceptions that were put into place by judicial principles and legislative changes prior to its ultimate repeal, see, for example, BITTKER & EUSTICE, *supra* note 26, ¶ 7.20 (4th ed. 1979); *see also* Bernard Wolfman, *Corporate Distributions of Appreciation Property: The Case for the Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81, at 5 (1985).

29. For distributions in redemption of stock, see I.R.C. § 302. For distributions in complete liquidation of the corporation, see I.R.C. § 331.

a buyer, there was no further gain to be realized on the sale except to the extent that the buyer paid more than the fair market value of the assets at the time of their distribution.[30] The buyer would take the assets with a basis equal to the buyer's purchase price.[31] This technique was widely understood[32] and widely utilized.[33] The ability to distribute appreciated assets out of corporate solution without incurring a corporate-level tax is exactly what Congress decided was in need of fundamental reform in 1986.[34]

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30. *Compare* Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945) (corporation was taxed on built-in gain on assets that were distributed prior to their sale by the shareholders because:

> the incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title),

with U.S v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454 (1950). (the Supreme Court refused to attribute a shareholder sale of distributed assets to the corporation where the shareholders had first attempted to sell their stock to the buyer and then offered to liquidate the corporation and sell the assets. The *Court Holding's* decision was distinguished because in *Court Holding* the sole purpose of the so-called liquidation was to disguise a corporate sale). The uncertainty caused by these two cases led Congress, in 1954, to enact old § 337, which ordinarily eliminated a tax at the corporate-level on liquidation-sale transactions (except for recapture items, installment obligations, and non-bulk sales of inventory), whether the sale was made directly by the corporation or was imputed to it under the *Court Holding Co.* doctrine. *Court Holding Co.*, 324 U.S. at 334. In addition, Congress allowed a buyer to treat the a stock purchase as if it were an asset purchase to step-up the basis of those assets while the seller was allowed to treat the transaction as a taxable stock sale. *See* I.R.C. § 334(b)(2) (1954). Congress replaced old § 334(b)(2) in 1982 with § 338, which now requires buyer and seller to take consistent positions on whether a transaction is an asset sale or stock sale. *See Tax Equity and Fiscal Responsibility Act of 1982*, Pub. L. 97-248 § 224, 96 Stat. 324, 485-90. And, Congress repealed old § 337 in 1986 because its continued existence was inconsistent with the repeal of the *General Utilities* doctrine.

31. *See* I.R.C. § 1012(a) (2012).

32. *See, e.g.*, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 102–19 (1982); Peter L. Faber et al., *Income Taxation of Corporations Making Distributions With Respect to Their Stock*, 37 TAX LAW. 625, 627, 628-30 (1984) (discussing the ABA Section of Taxation Task Force Report); Edward J. Hawkins, *A Discussion of the Repeal of General Utilities*, 37 TAX LAW. 641, 644-45 (1984); John S. Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97, 97, 100 (1985); Wolfman, *supra* note 28, at 1-4.

33. *See, e.g.*, Esmark, Inc. v. Comm'r, 90 T.C. 171, 181-82 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989); Zenz v. Quinlivan, 213 F.2d 914, 915, 917 (6th Cir. 1954).

34. See H.R. REP. NO. 99-426, at 282 (1985) ("[T]he *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee

Thus, in the paradigm that existed prior to 1980 where corporate rates were 33% lower than the top individual tax rate,[35] a strong incentive existed to conduct active business operations through a C corporation and to accumulate and reinvest earnings at the lower C corporate tax rate.[36] The issue then would turn to how to bail-out those corporate earnings to the shareholder at favorable capital gains rates.[37] The judicial doctrines of business purpose, device, and step transaction doctrine grew out of an era where the courts attempted to provide some defense to tax planning strategies that inappropriately avoided corporate-level and/or shareholder-level tax.[38] The Tax Reform Act of 1986 (hereafter, the "**1986 Tax Reform Act**") changed the tax rate paradigm and in so doing fundamentally altered the taxpayer's choice of business entities in the post-1986 era in comparison to the choices made in the pre-1986 era.[39]

B. *Tax Reform Act of 1986*

In 1986, except for distributions that qualify for non-recognition treatment under section 355,[40] Congress repealed the

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without the imposition of a corporate-level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax.").
"The price of this basis step up is, at most, a single shareholder-level capital gains tax (and perhaps recapture, tax benefit and other similar amounts). In some cases, moreover, payment of the capital gains tax is deferred because the shareholder's gain is reported under the installment method." *Id.* at n.28.

35. PECHMAN, *supra* note 25, at 303 (discussing that 70% top individual tax rate x (1-33%) = 46% top corporate tax rate).

36. See BITTKER & EUSTICE, *supra* note 26, ¶ 1.02:

> Under the Code, corporate income is taxed to the corporation, and the shareholders are taxed only when, as, and if the corporate earnings are distributed to them. This means that the corporation's undistributed earnings are taxed at the relatively flat, or nongraduated, corporate income tax rates and are not subjected to the more steeply graduated individual income tax rates. The contrast between the corporate and individual rates was sharper before World War II, but even now the marginal rate on individuals ranges from 14 percent to 70 percent while the corporate rate is 22 percent of the first $25,000 of taxable income and 48 percent of the balance. . . . The disparity between the relatively flat corporate rates and the graduated individual rates is a constant inducement to the accumulation of business or investment income in a corporation, where it will be shielded from a hostile tax collector

(footnotes omitted); *Id.* at ¶ 8.01 (4th ed. 1979).

37. *See* BITTKER & EUSTICE, *supra* note 26, ¶ 10.02 (4th ed. 1979) (detailing preferred stock bail-out answered by § 306); *see also id.* ¶ 13.06 (discussing device restrictions to prevent the use of § 355 to inappropriately bail-out earnings and profits without shareholders reporting dividend income).

38. *See id.* ¶¶ 11.06[1], 12.61[1], 12.61[3] (7th ed. 2000 & Supp. 2013).

39. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 601, 100 Stat. 2085, 2249.

40. I.R.C. § 355 (2012). In 1990, Congress subsequently tightened the restrictions

last vestiges of the *General Utilities* doctrine.[41] The intent of that major tax reform effort was to ensure that built-in gain property residing in corporate solution would be subject to corporate-level taxation when and if such property were distributed out of corporate solution[42] except where the taxpayer was able to meet the rigorous requirements of section 355.[43] Congress viewed the repeal of the *General Utilities* doctrine as a major reform effort that had a broad reaching impact.[44] In this regard, the 1986 Tax Reform Act was premised on the "classic view" that a corporation should be taxed separately from and in addition to the tax imposed on its owners.[45] Thus, appreciated corporate assets could no longer be distributed as part of a liquidating distribution to the shareholders without incurrence of a corporate-level tax, and Congress authorized the Treasury Department to issue regulations to ensure that the purposes of the repeal of the *General Utilities* doctrine were not circumvented through the use of any provision of the law or regulations.[46] At

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on I.R.C. § 355 by enacting I.R.C. § 355(d) to further protect against the use of I.R.C. § 355 as a technique to indirectly sale a subsidiary without corporate-level gain. *See* Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11321, 104 Stat. 1388-460, 1388-460 to 463.

41. *See* Tax Reform Act of 1986, § 631(a); *see also id.* § 631 (amending I.R.C. §§ 311(b)(2) and 336(a)).

42. *See* H.R. REP. NO. 99-841, at II-204 (1986) (Conf. Rep.)("The repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context.").

43. *See* I.R.C. § 355(c)(2) (2012).

44. *See* Tax Reform Act of 1986 § 631(a).

45. *See* Don Leatherman, *The Scope of the General Utilities Repeal*, 91 TAXES – THE TAX MAGAZINE 235, 237 (2013).

46. *See* I.R.C. § 337(d) (1987). Shortly after the 1986 Tax Reform Act, techniques were developed to circumvent the repeal of the *General Utilities* doctrine. One such technique, the son-of-mirror transaction, involved a situation in which an acquiring company would acquire the stock of a target company at fair market value. After the acquisition, the acquiring company would cause the target company to distribute its wanted assets to the acquirer, thus generating gain within the acquirer's consolidated group and thereby increasing the acquirer's basis in the stock of the target by the amount of that gain. The acquirer then could sell the target's stock at a time when the target company held only unwanted assets. As a result, an artificial loss was created that approximated the amount of the previously recognized gain that occurred upon the distribution of the wanted assets out of the target. The IRS immediately responded to the son-of-mirror technique by issuing I.R.S. Notice 87-14, 1987-1 C.B. 445, stating that it would deny the intended tax benefits of a son-of-mirror type transaction by future regulations that would have retroactive effect. On Sept. 19, 1991, the IRS and Treasury Department published Treas. Reg. § 1.1502-20 (2008) (the loss disallowance rule). *See* T.D. 8364, 1991-2 C.B. 43. On July 6, 2001, in *Rite Aid Corp. v. United States,* 255 F.3d 1357, 1359 (Fed. Cir. 2001), the Court held that the duplicated loss provisions of the loss disallowance rules were an invalid exercise of regulatory authority. Because only the loss duplication factor of Treas. Reg. § 1.1502-20 (2008) was at issue in *Rite Aid*, the IRS believes that the finding of invalidity applied only to that factor and not to the factors

the time, there were calls to adopt an integrated shareholder-corporate tax regime,[47] but those calls were rejected.[48]

Furthermore, in what turned out to be a profound change, the 1986 Tax Reform Act reduced individual tax rates to a maximum tax rate of 28% while the maximum corporate tax rate, which had historically been lower than the individual tax rate, was reduced to 34%.[49] In subsequent years, the top individual tax rate was subsequently made equivalent to the corporate tax rate.[50] And for 2013, the top individual tax rate is now slightly higher than the highest marginal corporate tax rate.[51]

The effect of this rate inversion (higher or equivalent corporate tax rates versus individual tax rates from 1986 through

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dealing with the son-of-mirror problem. *See* I.R.S. Notice 2002-11, 2002-1 C.B. 526 ("It is the Service's position that the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation . . . ."). In response to the *Rite Aid* decision, the IRS and Treasury Department promulgated two regulations to replace the loss disallowance rules. The first, Temp. Treas. Reg. § 1.337(d)-2T (2002) (temporary *General Utilities* regulation), was published on Mar. 12, 2002, to address the circumvention of *General Utilities* repeal. *See* T.D. 8984, 2002-1 C.B. 668. The second, Temp. Treas. Reg. § 1.1502-35T (2003), was published on Mar. 14, 2003, to address the inappropriate duplication of loss. *See* T.D. 9048, 2003-1 C.B. 644. T.D. 9048 also included certain related provisions promulgated under Temp. Treas. Reg. § 1.1502-21T (2010) and Temp. Treas. Reg. § 1.1502-32T (2003). *Id.* On Mar. 3, 2005, the temporary regulation was adopted without substantive change as final Treas. Reg. § 1.337(d)-2 (2005). *See* T.D. 9187, 2005-1 C.B. 778. On Sept. 17, 2008, the IRS and Treasury Department issued final unified rules for loss on subsidiary stock through Treas. Reg. § 1.1502-36 (2008). *See* T.D. 9424, 2008-2 C.B. 1012. For a discussion of the final unified loss disallowance regulations that now represent the end of this sordid tale, See David B. Friedel, *Final Loss Disallowance Rules: A New World Order*, 35 CORP. TAX'N 33 (2008) ("To call these final rules complicated would be a great understatement."). For a thorough analysis of the final regulations, *See* Don A. Leatherman, *A Survey of §1.1502-36*, THE CORPORATE TAX SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, REORGANIZATIONS, & RESTRUCTURINGS (2010).

47. *See* OFFICE OF THE PRESIDENT OF THE UNITED STATES, THE PRESIDENT'S TAX PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985); OFFICE OF THE SECRETARY OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 134-94 (1984). For an analysis of efforts for shareholder-corporate integration in the post-World War II era, *see* Steven A. Bank, *The Rise and Fall of Post-World War II Corporate Tax Reform*, 73 LAW & CONTEMP. PROBS. 207 (2010).

48. Don A. Leatherman, *A Survey of §1.1502-36, The Corporate Tax Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Reorganizations, & Restructurings*, PRAC. L. INST. No. 27151 (2010).

49. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2268, 2269 & 2270.

50. *Compare* I.R.C. § 1(a), *with* I.R.C. § 11(a). For a historical graph of the relationship of the top individual tax rate compared with the top corporate tax rate, see, for example, Catherine Mulbrandon, *Top Marginal Tax Rates 1916-2010*, VISUALIZING ECONOMICS (Apr. 11, 2011), http://visualizingeconomics.com/blog/2011/04/14/top-marginal-tax-rates-1916-2010.

51. *Compare* I.R.C. § 1(a) (2012) (highest marginal tax rate for individuals is 39.6%), *with* I.R.C. § 11(a) (2012) (highest marginal tax rate for corporations is 35%).

2012)[52] caused business income earned within C corporate solution to bear a higher ongoing tax cost than would be the case if those same business profits were instead earned in a pass-through entity that was subject to tax at the lower individual tax rate.[53]

Congress left taxpayers with the discretion to decide whether to conduct their business activities in a C corporation form or instead in a pass-through entity form.[54] Thus, notwithstanding Congress's bold effort to preserve the corporate tax base via the repeal of the *General Utilities* doctrine, it is a great historical irony that the 1986 Tax Reform Act (which purported to protect the corporate tax base by repealing the *General Utilities* doctrine) was in fact the death-knell for a broad-based corporate income tax for closely-held businesses in America.[55] The seeds of the destruction of the corporate tax base

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52. The double tax was ameliorated somewhat by enactment of the 15 percent rate on dividends and capital gains in 2003. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, § 301, 117 Stat. 752. However, even with this reduced rate, the total tax burden for the C corporation form is still higher at forty-four point seven five (44.75%) (Thirty-five percent (35%) corporate tax plus fifteen percent (15%) multiplied by sixty-five (65%) after-corporate tax profits) versus the top individual tax rate of thirty-five percent (35%) under current law. This provision was originally set to expire for tax years beginning after December 31, 2008, but the sunset date for the preferential fifteen percent (15%) rate on dividends and capital gains was extended to December 31, 2010, by the Tax Increase Prevention and Reconciliation Act of 2005 Pub. L. 109-222, § 102, 120 Stat. 345, 120 (2006). Congress again extended the sunset date to December 31, 2012, in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, § 101(a)(1), 124 Stat. 3296, 3298. The Obama administration criticized any further extension of the sunset date. *See* Press Release, President Barack H. Obama, Remarks after Congress Approval of the 2011 Debt-Limit Increase Deal (Aug. 2, 2011), *reprinted in* TAX NOTES TODAY, Doc 2011-16835, *available at* 2011 LEXIS TNT 149-22. However, in the end, Congress and the Obama Administration agreed to legislation that preserved capital gains preferences but set the tax rate on qualified dividends at twenty percent for high-income taxpayers. *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318-19 (2013).

53. The implications of the entity structure choice of the 1986 Tax Reform Act were recognized early on. For example, Professor Martin Ginsburg stated the following shortly after the enactment of the 1986 Tax Reform Act:

> [I]n the new inverted tax rate world it is not sensible for individuals to invest through the medium of a C corporation, and ordinarily (§ 469 tax planning may provide exceptions) it is not sensible as a matter of tax planning . . . for individuals to operate business activities through the medium of a C corporation. It follows that new enterprises likely will be organized in pass-through form, as proprietorships or partnerships or S corporations, and all manner of efforts will be made in existing C corporations to lift the burden of the corporate tax from future income streams. . . .

See Martin Ginsburg, *Tax Rates, Capital Gains and Losses, and C and S Corporations After the 1986 Act,* 22 SOUTH. FED. TAX INST., at J-13(1987).

54. *See* I.R.C. § 1362(a)(1)(2012).

55. Some legal scholars anticipated this result:

> After 1982, however, the highest top individual rate was no longer substantially higher than the top corporate rate, and in 1988 the top rates are scheduled to

were planted (via inverting rates where corporate tax rates exceeded the top individual tax rate), and this rate inversion occurred at the very instance Congress was professing to defend the corporate tax base.[56]

C. *Post-1986 Reaction*

In response to the reforms implemented as part of the 1986 Tax Reform Act,[57] the tax community has engaged in an ongoing effort to migrate closely-held businesses into pass-through entity structures to access the preferential individual tax rates.[58] As a consequence, an impressive number of C corporations have been electing to change from C corporation status to S corporation status.[59] This trend can be traced back to the adoption of the reforms implemented as part of the 1986 Tax Reform Act.[60] However, there are some limitations on the utility of such conversions.

> invert—that is, the top corporate rate of 34 percent will exceed the top noncorporate rate of 28 percent. Thus, the incentive to *organize* corporations for tax-avoidance purposes is significantly reduced.

BITTKER & EUSTICE, *supra* note 26, ¶ 8.01.

56. *See* Calvin H. Johnson, *The Incredible Shrinking Domain of Corporate Stock*, TAX NOTES, May 17, 2004, at 871-72.

57. Professor Ginsburg succinctly articulated the change in the historical norm in 1987 when he said the following: "until now the maximum individual rate has been higher, and more often than not a great deal higher, than the maximum corporate rate, so that closely held corporations operated and invested as partial tax shelters for the benefit of their shareholders."

Ginsburg, *supra* note 53 at J-13.

58. According to calculations based on IRS Statistics of Income data from 2004 to 2008, individual owners of flow-through businesses earned 54 percent of all business net income. ROBERT CARROLL & GERALD PRANTE, ERNST & YOUNG, *THE FLOW-THROUGH BUSINESS SECTOR AND TAX REFORM* 6 (2011), *available at* http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf (citing Internal Revenue Service, Statistics of Income, Corporate Source Book and Individual Tax Returns (publication 1304), selected years; computations by Ernst & Young LLP).

59. During the 2000-2006 time period, between 78,000 and 97,000 C corporations converted to S corporations per year, representing 23% to 31% of all new corporations. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATIONS TAX RULES 4 (2009).

60. Whereas the annual growth in the number of S corporation returns was 9.5 percent during the 1959-1986 period, the number of S corporations grew by more than 36 percent between 1986 and 1987. George A. Plesko, *The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986*, at 7 (1995), http://web.mit.edu/gplesko/www/Plesko%20Sconv.pdf. S corporations represented approximately 5% of businesses in 1986. *See* STAFF OF J. COMM. ON TAXATION, 110th CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 8 (2008), *available at* https://www.jct.gov/publications.html?func=startdown&id=1291. In 2006, S corporations represented 12.6% of all businesses and grew by 35% from 2000 to 2006 to account for nearly 4 million businesses. TAX GAP, *supra* note 59, at 3.

In this regard, S corporation status allows pass-through treatment for income earned prospectively.[61] However, Section 1374 imposes a tax on a converted C corporation's built-in gains[62] that are recognized during the prescribed post-S election recognition period.[63] As a result, where possible, tax advisors have advised closely-held businesses to convert from C corporation status to S corporation status, and then to delay any sale of appreciated built-in gain assets until after the close of the Section 1374 recognition period.[64] Such planning can work to minimize corporate-level tax under certain circumstances.[65] However, given the extended length of the recognition period for purposes of Section 1374's application (a minimum of seven years for dispositions occurring in 2009 and 2010,[66] a minimum of five years for dispositions occurring in 2011,[67] and a minimum of ten years for dispositions occurring in all other years),[68] this delay is

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61. Bret Wells & Craig Bergez, *Disposable Personal Goodwill, Frosty the Snowman, and* Martin Ice Cream *All Melt Away in the Bright Sunlight of Analysis,* 91 NEB. L. REV. 170, 177 (2013); *see also* I.R.C. § 1363 (2012)(explaining the computation of an S corporation's taxable income).

62. In general terms, built-in gain is the amount by which the fair market value of the assets of the converted C corporation exceed the aggregate adjusted bases of the assets. I.R.C. § 1374(d)(1) (2012). The tax is imposed if (i) the S-election was made after 1986; (ii) the converted C-corporation has a net recognized built-in gain within the recognition period; and (iii) the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for prior years in the recognition period, to the extent that such gains were subject to tax. *Id.* § 1374(c)(2).

63. The "recognition period" generally is the ten-year period beginning on the first day on which the corporation is taxed as an S corporation or acquires C corporation assets in a carryover basis transaction. *Id.* § 1374(d)(7)-(8). Thus, a disposition of appreciated property during this period of time will be subject to a corporate-level tax in addition to the shareholder-level tax. However, Congress has shortened the recognition period in two instances. First, for taxable years beginning in 2009 and 2010, no tax is imposed on the net-built in gain recognized in either of those years if the seventh taxable year is in the 10-year period preceding that taxable year. *Id.* § 1374(d)(7)(B)(i). The second instance where Congress shortened the recognition period was in The Small Business Jobs Act of 2010, which temporarily shortens the recognition period to five years but only for dispositions occurring in taxable years beginning in 2011. Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2014, 124 Stat. 2504, 2556. The tax is computed by applying the highest corporate income tax rate to the converted C corporation's net recognized built-in gain for the taxable year. *Id.* § 1374(b)(1).

64. *See* Wells & Bergez, *supra* note 61, at 177.

65. *Id.*

66. I.R.C. § 1374(d)(7)(B), *amended by* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1251(a), 123 Stat. 115, 342.

67. The Small Business Jobs Act reduced the S corporation built-in gain holding period from ten years to seven years for dispositions occurring during 2009 and 2010 and to five years for dispositions occurring during 2011. Small Business Job Act § 2014(a), 124 Stat. at 2556.

68. I.R.C. § 1374(d)(8)(B)(i) (2012); S. REP. NO. 100-445, at 65 (1988), *reprinted in* 1988 U.S.C.C.A.N 4515, 4587.

unacceptably long when the shareholders desire to sell the business in the near future.[69] What is more, the conversion to S corporation status imposes mechanical restrictions on the number of shareholders, the types and residency of shareholders, and the types of stock that can be owned by the shareholders.[70] Thus, although conversion to an S corporation provides a path to avoid corporate-level taxation, the election of S corporation status is not an immediate path to the avoidance of corporate-level tax on appreciated built-in gain property and creates some operational and ownership constraints that would not exist if the company were operated in a partnership or C corporation form.

Another alternative for reducing exposure to corporate-level taxation is to convert from C corporation status to partnership status.[71] Since the advent of the so-called "check-the-box" regime in 1997, taxpayers have been given the ability to elect the tax classification of business entities organized as partnerships or limited liability companies under state law.[72] Accordingly, taxpayers are able to preserve the non-tax benefits of corporate status (principally limited liability) while converting to an organizational form that can be taxed as a partnership for federal tax purposes.[73] However, in light of the repeal of the *General Utilities* doctrine, a significant disadvantage of this alternative is that the conversion of an existing C corporation into a tax partnership generally represents a taxable event to both the C corporation and its shareholders.[74] Depending on the existence of tax attributes such as a net operating loss carryforward or upon the valuation of the overall business, such tax planning may nonetheless make sense (particularly in a market downturn).

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69. *See, e.g.*, Martin Ice Cream Co. v. Comm'r, 110 T.C. 189, 191, 203 (1998) (Martin Ice Cream, an historic C corporation, elected S corporation status on November 1, 1987 but was sold shortly thereafter on July 22, 1988).

70. *See* JOEL D. KUNTZ & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 5.01 (4th ed. 2001 & Supp. June 2011).

71. Treas. Reg. § 301.7701-3(g)(1)(ii) (2006). The total number of partnerships actually declined between 1986 and 1987 due in part to changes to the passive activity loss rules, but the amount of income reported by partnerships with positive ordinary income increased by 9 percent during that period. SUSAN NELSON AND TOM PETSKA, PARTNERSHIPS, PASSIVE LOSSES, AND TAX REFORM at 31 (1989), http://www.irs.gov/pub/irs-soi/81-87papltxrf.pdf.

72. Treas. Reg. § 301.7701-1 (as amended by T.D. 8697, 61 Fed. Reg. 66588), The effective date of the regulations was January 1, 1997. *See also* I.R.S. Notice 95-14, 1995-1 C.B. 297; Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e).

73. Treas. Reg. § 301.7701-3(g)(1)(ii) (2006).

74. I.R.C. § 311(b)(3) (2012).

D. *Section 7704*

Shortly after the 1986 Tax Reform Act was enacted, several publicly traded companies attempted to dis-incorporate by means of the use of a master limited partnership.[75] In response to this effort, in order to protect the corporate tax base from what Congress perceived to be a significant threat,[76] Congress enacted Section 7704 which in general prevents publicly traded entities (with some important exceptions) from being treated as pass-through entities.[77] However, although Congress responded to protect against the dis-incorporation of the corporate tax base with respect to publicly-traded entities through the enactment of Section 7704, Congress again in 1987 left in place the ability of taxpayers to utilize partnerships or S corporations for non-publicly traded businesses.[78]

The result of the inverted rate structure on corporate structure choices by taxpayers in the post-1986 period is summarized in the below chart prepared by the Joint Committee on Taxation: [79]

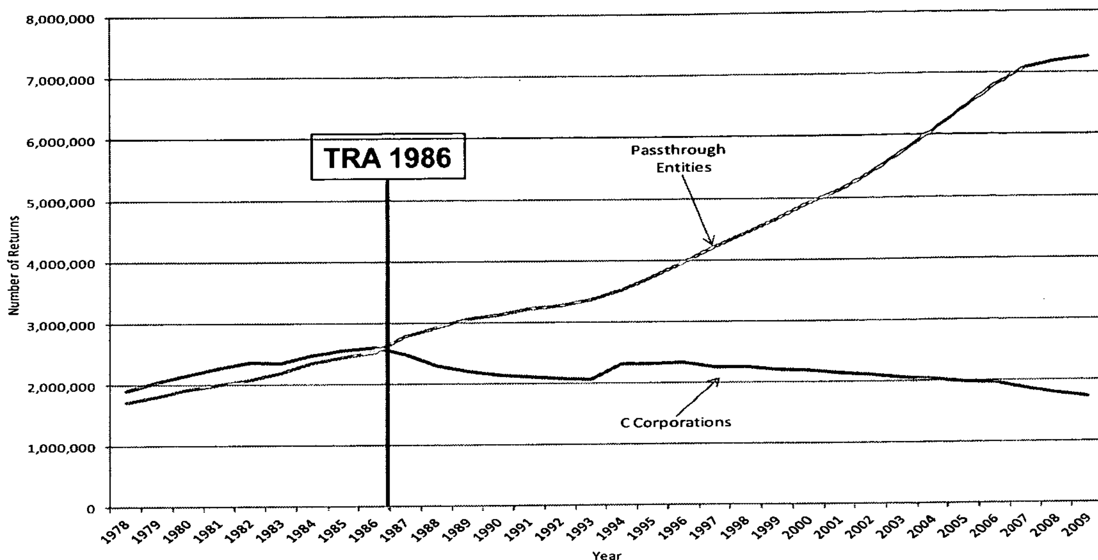
75. H.R. REP. NO. 100-391, pt. 2, at 681 (1987).

76. *See* Marvin F. Milich, *Master Limited Partnerships,* 20 REAL EST. L.J. 54, 63 (1991).

77. Congress enacted I.R.C. § 7704 in the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330-403 (1987); this public law also enacted I.R.C. § 469(k), which applies the passive loss rules to master limited partnerships, and I.R.C. § 512(c)(2), which treats income from master limited partnerships as unrelated trade or business income.

78. *See* I.R.C. §§ 701-777 (2012); *See id.* §§ 1361-1379 (2012).

79. STAFF OF J. COMM. ON TAXATION, TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SELECT COMMITTEE ON DEFICIT REDUCTION, JCX-49-11 at 10 (2011), *available at* https://www.jct.gov/publications.html?func=startdown&id=4363 (the line in the above chart that highlights the 1986 date was added by the authors); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 6, at 6.



As indicated in the above chart, the use of C corporations to conduct business activity continues to decline, and so the corporate income tax applies to a shrinking subset of the business activities that are conducted within the United States while income earned in pass-through entities continues to grow.[80] Thus, although Congress blocked the exit for most publicly-traded companies through the adoption of Section 7704, it left in place the means of side-stepping the corporate tax regime for non-publicly traded companies by leaving the choice of entity decision with taxpayers,[81] and taxpayers have systematically chosen to conduct their business in pass-through entity structures in the post-1986 era.[82]

E. *Corporate Tax Reform Implications*

The above analysis supports the assertion that the explosive growth of pass-through entities is a direct result of the rate inversion that was put into place by the 1986 Tax Reform Act and has existed from 1986 through 2012.

If individual tax rates on active business income remain at 39.6% and if the top corporate tax rate were reduced to 28%, then Congress would have created a rate structure where corporate

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80. *See* Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by $140 Billion*, 130 TAX NOTES 987 (2011).

81. *See* Treas. Reg. § 301.7701-3(a) (as amended in 2006).

82. *See* Sullivan, *supra* note 80.

tax rates are significantly less than the top individual tax rate,[83] and in so doing Congress would return America back to its pre-1980 tax rate paradigm. Faced with the pre-1980 tax rate paradigm, many if not most closely-held businesses that are currently conducting their businesses activities in pass-through entities would find it preferable to conduct those operations in C corporation form just as taxpayers largely chose to do prior to the paradigm shift created by the 1986 Tax Reform Act. If the business owner needed access to a portion of the corporation's profits on a current basis in the pre-1980 tax rate paradigm, then the business owner would look to tax strategies that could allow for cash to be transferred to the shareholder in tax deductible ways (salary, interest on loans, etc.) to avoid the corporate level tax on those periodic cash transfers to shareholders.[84]

However, even without such strategies, assuming that earnings are expected to be reinvested for four years, the facts in **Illustration #2** demonstrate that taxpayers gain a time value of money benefit if they conduct their business activities in a C corporation form. Thus, tax reform along the lines advocated by the Obama administration would return the country back to the pre-1980 tax rate paradigm with two fascinating differences.

First, unlike the pre-1986 era, corporate earnings can now be distributed as qualified dividends that are in turn subjected to shareholder taxation at favorable capital gains rates without the need to engage in complicated bail-out strategies.[85] Now that this preferential capital gains treatment afforded to qualified dividends has existed for more than a decade, Congress should consider simplifying Subchapter C to remove those provisions that attempted to prevent shareholders from bailing out corporate earnings at favorable capital gains rates since those safeguards are no longer relevant.

Second, if § 1202(a)'s 100% capital gain exclusion with respect to qualified small business stock were made permanent as proposed by the Obama administration[86] and as proposed by

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83. *See* I.R.C. § 1(c)(2012). (39.6% x (1-29%) = 28% hypothetical top corporate tax rate).

84. STEPHEN SCHWARZ & DANIEL LATHROPE, FUNDAMENTALS OF CORPORATE TAXATION: CASES AND MATERIALS, at 8 (8th ed. 2012).

85. For a discussion of the intricate efforts by shareholders to bail-out corporate earnings at favorable capital gains rates under the paradigm that existed prior to the 1986 Tax Reform Act, see BITTKER & EUSTICE, *supra* note 26, ¶ 10 (preferred stock bail-outs) and ¶ 13.06 (device restrictions of § 355) (4th ed. 1979); *see also id.* ¶¶ 10, 13.06 (3rd ed. 1971).

86. *See* DEP'T OF THE TREASURY 2013, *supra* note 5, at 37-38; *see also* STAFF OF S. FIN. COMM., *supra* note 7, at 7.

the staff of the Senate Finance Committee,[87] then § 1202 would provide an ongoing path to entirely avoid shareholder-level tax,[88] and as a result § 1202 would become a rich source of creative dispositional tax planning since it provides a tax-free result without the need to rely on the existing corporate reorganization provisions of § 368.[89] The U.S. tax laws have struggled with "mixing bowl" structures,[90] Midco structures,[91] and have looked at "anti-stuffing" rules[92] to combat aggressive tax planning techniques in other contexts. One would expect that similar safeguards would need to be added into § 1202(a) in order to set boundaries on taxpayer efforts to repackage unwanted corporate assets or unwanted corporations shortly before their disposition into an appropriately aged "qualified small business corporation wrapper." Furthermore, when the tax laws have based favorable tax rates on the size of a company, Congress has felt the need to add provisions that prevent taxpayers from divvying up their

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87. *See* STAFF OF S. FIN. COMM., *supra* note 7, at 7.

88. It is important to remember that § 1202 has only existed in the post-1986 inverted tax rate environment, so it has been a minor opportunity as most closely-held businesses have chosen to conduct their activities in pass-through entity structures. The permanent adoption of § 1202 coupled with a return to the pre-1986 tax rate paradigm represents a game-changer that would elevate § 1202 to a significant provision for many closely-held businesses. In this regard, § 1202 was added to the tax laws for the first time in 1993. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,113(a), 107 Stat 312, 422-429 (allowed 50% gain exclusion when capital gains rates were 28%). In 1997, Congress enacted § 1045 that allowed tax-free roll-over of qualified business stock. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 313(a), 111 Stat. 788, 841-842. In 2003, when Congress reduced long-term capital gains rates to 15% and did not alter the 28% tax rate on qualified business stock. *See supra* note 52, Pub. L. No. 108-27, § 301(a), 117 Stat 752, 758. As a result, during this period § 1202 could create a tax disadvantage for taxpayers eligible for a zero or 5% long-term capital gains rate as § 1202 is not elective in its application. *See* Anthony P. Polito, "*Small Bus Corp Stock: Special Tax Incentives*," 760-2d Tax Mgmt Portfolios (BNA), at A-38 (2005). In 2009, Congress temporarily increased the gain exclusion to 75%. *See* American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, § 1241(a), 123 Stat 115, 342. Gain realized after September 27, 2010 and before January 1, 2011 was entitled to a 100 percent exclusion. *See* Small Business Jobs Act, *supra* note 63, §§ 2011(b), 2554 (2010). The 100 percent exclusion was extended to stock acquired before January 1, 2012. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, *supra* note 52, § 760, at 3323. The 100 percent exclusion was extended to stock acquired before January 1, 2014. *See* American Taxpayer Relief Act of 2012, *supra* note 52, § 324(b), at 2333.

89. *See* I.R.C. § 1202, 368 (2012).

90. *See* I.R.C. §§ 704(c)(1)(B), 737 (2012) (attempting to prevent partnerships from being used as a "mixing bowl" to sell unwanted assets through a partnership structure).

91. For an example of using an intermediary tax-preference "Midco" in an analogous context, see I.R.S. Notice 04-20, 2004-1 C.B. 608 (2004).

92. For an example of an anti-stuffing rule needed to prevent inappropriate usage of tax attributes in a disposition transaction, see I.R.C. §§ 336(d)(2), 382(l)(1) (2012); Treas. Reg. §§ 1.367(a)-3(c)(3)(iii)(B)(1), 1.367(e)-2(b)(1)(ii)(C) (2012).

businesses among multiple corporations,[93] and a similar concern would need to be addressed in the § 1202 context since its gain exclusion only exists with respect to the disposition of certain "small" corporations. Finally, significant thought would be required to ensure that § 355 spin-offs of controlled subsidiaries do not inappropriately access § 1202's gain exclusion.[94]

The permanent addition of § 1202's 100% gain exclusion along with a return to the pre-1980 tax rate paradigm represents the place where real attention should be placed because the disposition of a closely-held business that would be eligible for § 1202(a) treatment creates an even better shareholder-level tax result than the one afforded in the period prior to the repeal of the *General Utilities* doctrine.[95] If Congress wants to create such a favorable result, then it should further articulate its policy rationale in this area so that taxpayers and scholars can further understand the scope of its largesse in the context of obvious taxpayer planning responses.

II. IMPLICATIONS FOR THE FUTURE

Pass-through entities represent a major conceptual challenge for policy-makers today. In this paper, I have been careful to avoid attacking simplification and harmonization of pass-through entity regimes. Such an effort is a fine goal, and harmonization of pass-through entity taxation may well make the U.S. tax laws better.[96] But, as Congress considers reform in this area, it is important to remember how we got here. Pass-through entities did not occupy its dominant position with respect to growth-oriented small businesses prior to 1986,[97] and the exponential growth in the importance of pass-through entity taxation since 1986 creates an impressive (but irrelevant) backdrop for the current business tax reform discussion. If tax

93. *See* I.R.C. § 1561 (2012).

94. Furthermore, Congress has attempted to restrict the ability to avoid corporate-level tax on pre-sale § 355 transactions that are part of a larger acquisitive transaction. *See* I.R.C. §§ 355(b)(2)(D); 355(d); 355(e) (2012). Whether § 355 needs further protections to prevent an inappropriate avoidance of shareholder-level tax represents an issue that arguably is unaddressed by these earlier legislation modifications to § 355.

95. Shareholders were taxed at capital gains rates in the pre-1986 era, which albeit a preferential rate was nevertheless more than a 100% exclusion. *See* BITTKER & EUSTICE, *supra* note 26, ¶ 1.03 (4th ed. 1979).

96. For thoughtful testimony on the desirability of harmonizing pass-through entity taxation, *see* Willard Taylor, *Testimony Before the Subcommittee on Select Revenue Measures of the Ways and Means Committee on the Discussion Draft to Reform the Taxation of Small Business and Passthough* [sic] *Entitites*, (May 15, 2013), *available at* http://waysandmeans.house.gov/uploadedfiles/taylor_testimony.pdf.

97. *See* STAFF OF J. COMM. ON TAXATION, *supra* note 79, at 10.

reform proceeds along the path outlined above, then pass-through entity taxation represents a minor issue because the pre-1980 tax rate paradigm provides small business taxpayers with a compelling economic incentive to exit pass-through entity structures in favor of C corporate entities.[98] Consequently, focusing on pass-through entity reform diverts attention away from the real policy issues that are relevant for the tax rate paradigm that Congress is contemplating. Of course, theoreticians and scholars would prefer that Congress harmonize pass-through entity taxation and perhaps harmonize pass-through entity taxation with C corporation taxation, but the failure to obtain theoretical synthesis between these two tax regimes is made irrelevant from a practical perspective in the scenario where corporate tax rates are significantly lower than individual tax rates.

When confronted with the specter of a significant reversal of individual and corporate tax rates, a Treasury Department official was quoted as having stated as follows:

> Corporate tax rates and individual tax rates have been historically all over the lot. Sometimes corporate rates are higher than individual rates. Sometimes individual rates are higher than corporate rates. We have in the depths of the tax code some provisions that would prevent taxpayers from arbitraging those rates. And so we'd have to basically resurrect those kinds of provisions if you did have a big gap between the individual and corporate rate. . . . From a tax administration standpoint, if you have big gaps between the two, you need to worry about folks trying to arbitrage them. I think really if you're thinking about trying to have a business tax system where the U.S. rates are competitive, you need to look at what rates around the rest of the world are. If you look at other countries, the rates can differ, so it's not crucial. It's just sort of where things land.[99]

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98. Some policy-makers appear to have accepted this expected outcome. *See* Lindsey McPherson, *GOP Lawmakers Question Obama's Commitment to Individual Reform*, 139 TAX NOTES 254 (2013) (quoting Representative Vern Buchanan, R-Fla., as stating that "small businesses will be left behind if Congress were to pursue only corporate tax reform" and "if the corporate rate is lowered and the individual rates remain the same,. . .many pass-through entities would choose to reorganize as C corporations.").

99. *See* Amy S. Elliot, *Scary Tax Reform Concepts Peddled by Policymakers*, 139 TAX NOTES 357 (2013).

The above observation under-emphasizes the profound impact that individual-versus-corporate tax rate differentials have had on the taxpayer's ultimate choice of business entity decision-making. In the pre-1986 era, Congress felt the need to police shareholder efforts to excessive accumulation earnings in C corporate solution by imposing an accumulated earnings tax[100] and by imposing an additional tax on personal holding companies,[101] but the efficacy of these provisions in achieving those goals in the pre-1986 era was debatable to say the least.[102] The rate inversion instituted by the 1986 Tax Reform Act made obsolete the use of C corporations as shelters because of the inverted tax rate paradigm that existed for most of the post-1986 era.[103] But, returning to the pre-1980 tax rate paradigm would resurrect those earlier policy concerns and bring them back into play. Furthermore, if the additional decision were made to enact § 1202 as a permanent provision, then an important path for avoiding any shareholder-level taxation would exist for these businesses owners who chose to reincorporate back into C corporation form to access the lower corporate-level tax rates.

The historical record prior to the 1986 Tax Reform Act indicates that Congress failed to fully appreciate the impact that inverted rates would have on the taxpayer's ultimate choice of business entity, and it appears that the same can be said today. If individual tax rates were to become significantly higher than corporate tax rates, this would cause taxpayer's to return to the pre-1980 tax planning thesis that dominated the landscape for closely-held businesses prior to the 1986 Tax Reform Act. In that pre-1986 Tax Reform Act paradigm, taxpayers were motivated to conduct their closely-held businesses in C corporate form.

A return to those same financial incentives thus brings back into focus different issues than what is currently in the press. The more germane questions would be whether the historic anti-abuse provisions of § 531 (excess accumulated earnings tax) and § 541 (personal holding company rules) are adequate answers to thwart individual taxpayer efforts to transfer more and more of their personal wealth into C corporate solution as a shield against the top individual tax rate.[104] Furthermore, if § 1202(a)'s 100% capital gains exclusion were made permanent, then

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100. I.R.C. § 531 (2012).

101. I.R.C. § 541 (2012).

102. *See* BITTKER & EUSTICE, *supra* note 26, ¶¶ 7.01-.24 (4th ed. 1979).

103. *See* STAFF OF J. COMM. ON TAXATION, *supra* note 79, at 6; Sullivan, *supra* note 80, at 987.

104. I.R.C. §§ 531, 541 (2012).

Congress should consider whether this permanent avoidance of shareholder-level taxes will need further anti-abuse protections against clearly foreseeable dispositional planning techniques that will seek to maximize the potential scope of § 1202. This is where further focus should be devoted, but Congress appears to be spinning its wheels by discussing pass-through entity taxation even though pass-through entity structures would become a relic of the prior era. Congress, public-policy advocates, and scholars need to dedicate significant time to the question of what tax rate disparity should exist for individual and C corporate tax rates. After addressing that issue, Congress needs to then address the extent that a capital gains preference should be given, particularly with respect to the generous preference given for capital gains on qualified small business stock. In that process, Congress needs to define boundaries for preventing those preferential rates from being inappropriately accessed.

At present, those questions have not been adequately addressed, but they need to be addressed. These questions need to be addressed because tax reform along the lines that have been reported in the press would have a transformative impact on the choice of entity decisions of closely-held businesses. Tax reform that creates a monumental paradigm shift in the business planning premises of closely-held businesses will bring about transformative reactive tax planning on the part of the business community. Consequently, before enacting such a significant paradigm shift, Congress should clearly articulate the policy goals of this new tax rate paradigm so that taxpayers will know which attempts to utilize C corporation vehicles as a mechanism to avoid the higher individual tax rate are acceptable and which such attempts cross the line. Where to draw the line is the historic challenge of the pre-1980 paradigm, but this reality has been shielded from our view due to the inverted rate structure that has existed since 1986 and the tempest in the teapot of pass-through entity structures that have flourished in the era of inverted tax rates.