

**TECHNICAL EXPLANATION OF THE WAYS AND MEANS
COMMITTEE DISCUSSION DRAFT PROVISIONS
TO REFORM THE TAXATION OF SMALL BUSINESSES
AND PASSTHROUGH ENTITIES**

March 12, 2013

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I. SUBTITLE B -- TAX REFORM FOR SMALL BUSINESSES

A. Part 1 -- General Provisions

1. Election to expense certain depreciable business assets (sec. 211 of the discussion draft and sec. 179 of the Code)

Present Law

A taxpayer may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.¹ In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2014 also is treated as qualifying property. For taxable years beginning before 2014, qualifying property also includes certain real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).²

For taxable years beginning in 2010, 2011, 2012, and 2013, the maximum amount a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.³ The \$500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000.⁴ The \$500,000 and \$2,000,000 amounts are not indexed for inflation. Of the \$500,000 expense amount available under section 179 for these years, the maximum amount available with respect to qualified real property is \$250,000 for each taxable year.

For taxable years beginning after 2013, a taxpayer may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property does not include off-the-shelf computer software or qualified real property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined

¹ Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

² Sec. 179(f).

³ For the 2008 and 2009 years, the relevant dollar amounts were \$250,000 and \$800,000 (enacted as part of The Economic Stimulus Act of 2008, Pub. L. No. 110-185, sec. 102(a) (2008)).

⁴ Sec. 179(b)(2).

without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However, amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.⁵ Thus, if a taxpayer's section 179 deduction for 2012 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2013. Any such carryover amounts that are not used in 2013 (due to taxable income limitations) are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount from 2012 is considered placed in service on the first day of the 2013 taxable year.⁶

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.⁷ In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner for taxable years beginning before 2014 (once made, such revocation is irrevocable).⁸

Explanation of Provision

The provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2013, is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000. The \$250,000 and \$800,000 amounts are indexed for inflation for taxable years beginning after 2014.

The provision makes permanent, for taxable years beginning after 2013, the treatment of off-the-shelf computer software as qualifying property, the treatment of qualified real property as

⁵ Section 179(f)(4) details the special rules that apply to disallowed amounts.

⁶ For example, assume that during 2012, a company's only asset purchases are section 179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$200,000. Assume the company has no other asset purchases during 2012, and has a taxable income limitation of \$150,000. The maximum section 179 deduction the company can claim for 2012 is \$150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated \$100,000 to the qualified leasehold improvements and \$50,000 to the equipment.

Assume further that in 2013, the company had no asset purchases and had taxable income of \$-0-. The \$100,000 carryover from 2012 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2013 taxable year. The \$50,000 carryover allocated to equipment is carried over to 2014 under section 179(b)(3)(B).

⁷ Sec. 179(c)(1).

⁸ Sec. 179(c)(2).

eligible section 179 property, and the special rule allowing an election or specification under section 179 to be revoked by the taxpayer without consent of the Commissioner.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2013.

2. Limitation on use of cash method of accounting (sec. 212 of the discussion draft and sec. 448 of the Code)

Present Law

Taxpayers using the cash receipts and disbursements method of accounting (the “cash method”) generally recognize items of income when actually or constructively received and items of expense when paid. Taxpayers using an accrual method of accounting generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.⁹ Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the right to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.¹⁰ An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.¹¹

A C corporation, partnership that has a C corporation as a partner, or a tax-exempt trust with unrelated business income generally may not use the cash method of accounting. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed \$5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the “gross receipts test”). The cash method of accounting may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.¹²

A farming business is defined under section 263A(e)(4) as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees. Such farming businesses are not precluded from

⁹ See, *e.g.*, section 451.

¹⁰ See, *e.g.*, section 461.

¹¹ See, *e.g.*, section 166.

¹² Sec. 471.

using the cash method regardless of whether their average annual gross receipts exceed \$5 million.¹³

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed \$5 million.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, that, on the basis of experience, will not be collected (the “nonaccrual experience method”).¹⁴ The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Explanation of Provision

The provision both expands and restricts the universe of taxpayers that may use the cash method of accounting. That is, the provision provides that the cash method of accounting may only be used by natural persons (*i.e.*, sole proprietors) and taxpayers other than tax shelters that satisfy the gross receipts test. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed \$10 million for the three prior taxable-year period to use the cash receipts and disbursements method, so long as use of such method clearly reflects income.¹⁵

The provision eliminates the exceptions for farming businesses and qualified personal service corporations such that they are subject to the general limitation on the use of the cash method of accounting (*i.e.*, generally precluded from using the cash method unless the farming business or personal service corporation satisfies the gross receipts test).

Under this provision, the nonaccrual experience method is retained. However, the rules are repealed in section 448 and are added as new subsection (j) under section 451.

In the case of any taxpayer required by this section to change its method of accounting for any taxable year, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

¹³ However, section 447 requires certain farming business to use an accrual method of accounting.

¹⁴ Sec. 448(d)(5).

¹⁵ Consistent with present law, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.

Effective Date

The provision applies to taxable years beginning after December 31, 2013. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

3. Repeal of required use of accrual method for corporations engaged in farming (sec. 213 of the discussion draft and sec. 447 of the Code)

Present Law

A corporation or a partnership with a corporate partner engaged in the trade or business of farming (other than the trade or business of operating a nursery or sod farm or the raising or harvesting of trees (other than fruit and nut trees)) must use an accrual method of accounting for such activities unless such corporation or partnership, for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding \$1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change.

Special rules apply for family farm corporations. A provision of the Revenue Act of 1987¹⁶ ("1987 Act") requires a family corporation or a partnership with a family corporation as a partner to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding \$25 million. A family corporation is one where 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change. The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation.

Explanation of Provision

The provision repeals the special method of accounting rules for corporations and partnerships with a corporate partner engaged in farming under section 447. Thus, taxpayers

¹⁶ Pub. L. No. 100-203.

engaged in the trade or business of farming will be subject to the general rules for methods of accounting.¹⁷

Effective Date

The provision applies to taxable years beginning after December 31, 2013. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

4. Modification of rules for capitalization and inclusion in inventory costs of certain expenses (sec. 214 of the discussion draft and sec. 263A of the Code)

Present Law

The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986,¹⁸ require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.¹⁹ For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have \$10 million or less of average annual gross receipts,²⁰ such taxpayers are not required to include additional section 263A costs in inventory.

Explanation of Provision

The provision expands the exception from the uniform capitalization rules. Under this provision, a taxpayer that produces tangible personal property and has \$10 million or less of average annual gross receipts is not subject to section 263A.

Effective Date

The provision applies to taxable years beginning after December 31, 2013. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

¹⁷ See, e.g., sections 446 and 448. For a discussion of a provision concerning section 448, see *infra* I.A.2, Limitation on use of cash method of accounting.

¹⁸ Pub. L. No. 99-514.

¹⁹ Sec. 263A.

²⁰ Sec. 263A(b)(2)(B).

5. Unification of deduction for start-up and organizational expenditures (sec. 215 of the discussion draft and secs. 195, 248, and 709 of the Code)

Present Law

A taxpayer may elect to deduct up to \$5,000 of start-up expenditures in the taxable year in which the active trade or business begins.²¹ A corporation or a partnership may elect to deduct up to \$5,000 of organizational expenditures in the taxable year in which the active trade or business begins.²² However, in each case, the \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds \$50,000.²³ Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins. Absent an election to deduct and amortize start-up or organizational expenditures, such amounts are properly chargeable to capital and recovered when the business is sold, exchanged, or otherwise disposed.

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Explanation of Provision

Under the provision, the rules for start-up expenditures and organizational expenditures are consolidated into a single provision. A taxpayer may elect to deduct up to \$10,000 of the sum of start-up and organizational expenditures in the taxable year in which the active trade or business begins. The \$10,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of the sum of start-up and organizational expenditures exceeds \$60,000. Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins.

Effective Date

The provision is effective for expenses paid or incurred after December 31, 2013.

²¹ Sec. 195(b)(1)(A).

²² Secs. 248(a)(1)(B), and 709(b)(1)(A)(ii).

²³ *Ibid.* However, for taxable years beginning in 2010, the Small Business Jobs Act of 2010, Pub. L. No. 111-240, increased the amount of start-up expenditures a taxpayer could elect to deduct to \$10,000, with a phase-out threshold of \$60,000.

B. Part 2 -- Tax Return Due Date Simplification

Present Law

Persons required to file income tax returns²⁴ must file such returns in the manner prescribed by the Secretary, in compliance with due dates established in the Code, if any, or by regulations. A partnership generally is required to file a Federal income tax return on or before the 15th day of the fourth month after the end of the partnership taxable year.²⁵ For a partnership with a taxable year that is a calendar year, for example, the partnership return due date (and the date by which Schedules K-1 must be furnished to partners) is April 15. However, a partnership is allowed an automatic five-month extension of time to file the partnership return and the Schedule K-1s (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.²⁶

A C corporation or an S corporation generally is required to file a Federal income tax return on or before the 15th day of the third month following the close of the corporation's taxable year. For a corporation with a taxable year that is a calendar year, for example, the corporate return due date is March 15.²⁷ However, a corporation is allowed an automatic six-month extension of time to file the corporate return (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.²⁸

²⁴ Section 6012 provides general rules identifying who must file an income tax return, while other Code provisions referenced herein specifically address filing requirements of partnerships, corporations, and other entities.

²⁵ Secs. 6031, 6072.

²⁶ Sec. 6081. Treas. Reg. sec. 1.6081-2. See Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3. Unlike other partnerships, an electing large partnership is required to furnish a Schedule K-1 to each partner by the first March 15 following the close of the partnership's taxable year (sec. 6031(b)). For calendar year 2012 partnerships, for example, the due date is March 15, 2013 even though the partnership return due date is April 15, 2013. However, an electing large partnership is allowed an automatic six-month extension of time to file the partnership return and the Schedule K-1s by submitting an application on form 7004 in accordance with the rules prescribed by the Treasury Regulations. Treas. Reg. sec. 1.6081-2(a)(2).

²⁷ Secs. 6012, 6037, 6072. Section 6012(a)(2) provides that every corporation subject to taxation under subtitle A shall be required to file an income tax return. Section 6037, which governs the returns of S corporations, provides that any return filed pursuant to section 6037 shall, for purposes of chapter 66 (relating to limitations) be treated as a return filed by the corporation under section 6012. Section 6072, which sets forth the due dates for filing various income tax returns, provides that returns of corporations with a taxable year that is a calendar year under section 6012 (and section 6037 based on the language in that section) are due March 15.

²⁸ Section 6081(b) provides that a corporation is allowed an automatic extension of three months to file its income tax return if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax. However, section 6081(a) provides that the Secretary may grant an automatic extension of up to six months to file and the Treasury regulations do so provide. Treas. Reg. sec. 1.6081-3.

The annual returns required to be filed by various Employee Benefit Plan are due on the last day of the seventh month following the close of the plan year, and may be extended up to the 15th day of the third month following the due date. For a calendar year plan, the original due date would be July 31, with a maximum extension until October 15.²⁹

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.³⁰ Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act³¹ provide additional guidance regarding the disclosure obligation with respect to foreign accounts. Treasury Department Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts,” (the “FBAR”) must be filed by June 30 of the year following the year in which the \$10,000 filing threshold is met.³²

1. New due date for partnership form 1065, S corporation form 1120S and C corporation form 1120 (sec. 221 of the discussion draft and sec. 6072 of the Code)

Explanation of Provision

The provision moves back the original filing date of Federal income tax returns of partnerships and moves forward the original filing date of Federal income tax returns of C corporations and S corporations.

The provision requires that the partnership return be filed on or before the 15th day of the third month following the close of the taxpayer’s taxable year, or March 15 in the case of a calendar year taxpayer. The provision requires that the S corporation return be filed on or before the last day of the third month following the close of the corporation’s taxable year, or March 31 in the case of a calendar year taxpayer.³³ The provision requires that the C corporation return be

²⁹ Treas. Reg. sec. 1.6081-11 permits an automatic extension.

³⁰ 31 U.S.C. sec. 5314. The term “agency” in the Bank Secrecy Act includes financial institutions.

³¹ 31 U.S.C. sec. 5314(a) provides: “Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.”

³² 31 C.F.R. sec. 103.27(c). The \$10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

³³ For a discussion of a provision concerning extending the time for making S corporation elections, see *infra* II.A.6, Extension of time for making S corporation elections.

filed on or before the 15th day of the fourth month after the close of a taxable year, or April 15 in the case of a calendar year taxpayer.

Effective Date

The provision is effective for returns for taxable years beginning after December 31, 2013.

Modification of due dates by regulation (sec. 222 of the discussion draft)

Explanation of Provision

The provision requires that the Treasury Department modify its regulations that establish extensions of due dates by conforming the extension periods to the following terms. The maximum extension for the returns of partnerships using a calendar year is a six-month period ending on September 15. The maximum extension for the returns of trusts using a calendar year is a 5-1/2 month period ending on September 30. The maximum extension for the returns of employee benefit plans using a calendar year is an automatic 3-1/2 month period ending on November 15. The maximum extension for the returns of tax-exempt organizations using a calendar year is an automatic six-month period ending on November 15. The due date for forms relating to the Annual Information Return of Foreign Trust with a United States Owner for calendar year filers is April 15 with a maximum extension for a six-month period ending on October 15.

In addition to requiring modification of the regulatory deadlines established for extensions of time to file income tax returns, the provision establishes a statutory due date for the form required under FBAR that generally conforms to income tax filing deadlines. Under the provision, the due date of forms relating to Report of Foreign Bank and Financial Accounts is April 15 with a maximum extension for a six-month period ending on October 15 (with a provision for extension). The provision permits the Secretary to waive any penalties for failure to file a timely request for an extension if the reporting period to which the penalty relates is the first period for which the taxpayer was subject to the FBAR requirements.

Effective Date

The provision is effective for returns for taxable years beginning after December 31, 2013.

2. Corporations permitted statutory automatic 6-month extension of income tax returns (sec. 223 of the discussion draft and sec. 6081 of the code)

Explanation of Provision

The provision modifies the statute to provide (consistent with current Treasury regulations) that a corporation is allowed an automatic six-month extension of time to file its Federal corporate income tax return (to October 15 for a calendar year taxpayer, assuming the new filing dates as described in section 221 above) if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax.

Effective Date

The provision is effective for returns for taxable years beginning after December 31, 2013.

II. SUBTITLE C -- [OPTION 1] PASSTHROUGH ENTITIES

A. Part 1 -- [Option 1] S Corporations

Overview

In general, an S corporation is not subject to corporate-level income tax. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses). A shareholder's loss may be deducted only to the extent of his or her basis in the stock or in debt of the S corporation to the shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

1. Reduced recognition period for built-in gains tax made permanent (sec. 231 of the discussion draft and sec. 1374 of the Code)

Present Law

In general

A small business corporation may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level income tax. Instead, items of income and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.³⁴

Under section 1374, a corporate level built-in gains tax, at the highest corporate income tax rate (currently 35 percent), is imposed on an S corporation's net recognized built-in gain.³⁵ This rule applies to gain that arose prior to the conversion of the corporation from a C corporation to an S corporation, and that is recognized by the S corporation during the recognition period, *i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect.³⁶ If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no tax under section 1374 is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized

³⁴ Sec. 1366.

³⁵ Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

³⁶ Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d). A regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment. Treas. Reg. secs. 1.1337(d)-7(b)(1) and (c)(1).

built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year (subject to the taxable income limitation in the succeeding taxable year).³⁷

Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.³⁸ The treatment of all payments received under the installment sale is governed by the provisions of section 1374(d)(7) applicable to the taxable year in which the sale was made.

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation.³⁹ In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.⁴⁰

The built-in-gain tax imposed on the corporation is in addition to the tax imposed on each shareholder on his or her share of the gain taken into account in computing the shareholder's taxable income. The amount of the built-in gain tax under section 1374 is treated as a loss by each of the S corporation shareholders in computing its own income tax.⁴¹

Special rules for taxable years beginning in 2009 thru 2013

Since 2009, Congress has enacted several temporary provisions that have generally shortened the period during which the built-in gains tax applies. For any taxable year beginning in 2009 and 2010, a seven-year period was applied, and for 2011 a five-year period was applied.⁴²

Most recently, for any taxable year beginning in 2012 and 2013, Congress provided a five-year recognition period.⁴³

³⁷ Sec. 1374(d)(2).

³⁸ Treas. Reg. sec. 1.1374-4(h).

³⁹ Sec. 1374(d)(8).

⁴⁰ Sec. 1374(d)(8)(B).

⁴¹ Sec. 1366(f)(2).

⁴² Secs. 1374(d)(7)(b)(i) and (ii).

⁴³ Sec. 1374(d)(7)(C).

Explanation of Provision

The five-year recognition period in effect for taxable years beginning in 2012 and 2013 is made permanent.

Effective Date

The provision is effective for taxable years beginning after December 31, 2013.

2. Modifications to S corporation passive investment income rules (sec. 232 of the discussion draft and secs. 1362 and 1375 of the Code)

Present Law

Passive investment income

An S corporation is subject to corporate-level tax at the highest corporate tax rate (currently 35 percent) on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, and annuities. Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, or certain interest and dividend income of banks and depository institution holding companies.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Explanation of Provision

The provision terminating the election of an S corporation having excess passive investment income for three consecutive taxable years is repealed. Instead, the corporation continues to be subject to tax on any excess net passive income.

The 25-percent threshold above which an S corporation's excess net passive income is subject to a corporate-level tax is increased to 60 percent.

Effective Date

The provision applies to taxable years beginning after December 31, 2013.

3. Expansion of qualifying beneficiaries of an electing small business trust (sec. 233 of the discussion draft and sec. 1361 of the Code)

Present Law

An electing small business trust (“ESBT”) may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.⁴⁴

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers (currently 39.6 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Explanation of Provision

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Date

The provision is effective on January 1, 2014.

4. Charitable contribution deduction for electing small business trusts (sec. 234 of the discussion draft and sec. 641(c) of the Code)

Present Law

An electing small business trust (“ESBT”) may be a shareholder of an S corporation. The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and is generally taxed on its share of the S corporation’s income at the highest rate of tax imposed on individual taxpayers (currently 39.6 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,⁴⁵ rather than the deduction applicable to individuals,⁴⁶ applies to the trust. Generally a

⁴⁴ Sec. 1361(b)(1)(C) and (c)(2)(B)(v).

⁴⁵ Sec. 642(c).

⁴⁶ Sec.170.

trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Explanation of Provision

The discussion draft provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather to the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to contributions made by the portion of an ESBT holding S corporation stock.

Effective Date

The provision applies to taxable years beginning after December 31, 2013.

5. Permanent rule regarding basis adjustment to stock of S corporations making charitable contributions of property (sec. 235 of the discussion draft and sec. 1367 of the Code)

Present Law

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.⁴⁷ A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.⁴⁸

In the case of contributions made in taxable years beginning before January 1, 2014, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2013, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

Explanation of Provision

The provision makes permanent the basis reduction rule in effect for contributions made in taxable years beginning before January 1, 2014.

⁴⁷ Sec. 1366(a)(1)(A).

⁴⁸ Sec. 1367(a)(2)(B).

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2013.

6. Extension of time for making an S corporation election (sec. 236 of the discussion draft and sec. 1362 of the Code)

Present Law

An election by a small business corporation to be treated as an S corporation may be made for any taxable year at any time during the preceding taxable year or at any time on or before the 15th day of the third month of the taxable year. An election continues in effect for subsequent taxable years until it is terminated.

An election is valid only if all persons who are shareholders in the corporation on the day on which the election is made consent to the election.

An election to be an S corporation made on or before the 15th day of the third month of a corporation's taxable year is effective beginning with the taxable year when made if (i) the corporation meets all eligibility requirements for the pre-election portion of the taxable year, and (ii) all persons who held stock in the corporation any time during the portion of the year before the election is made consent to the election.

If the eligibility requirements are not met for the entire pre-election portion of the year for which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the 15th day of the third month of the taxable year, the election becomes effective for the following taxable year.

An election may be revoked by the action of shareholders holding more than one-half of the corporation's voting stock.

Explanation of Provision

An election to be treated as an S corporation for a taxable year may be made not later than the due date (with extensions) for filing the corporation's return for the taxable year.⁴⁹ The election may be made on a timely filed return for the taxable year.

The Secretary of the Treasury may treat a revocation as timely made for a taxable year if the Secretary determines that there was reasonable cause for the failure to timely make the revocation.

⁴⁹ For a discussion of a provision to modify the filing date for the S corporation return and the current law, see *supra* I.B, Part 2 -- Tax Return Due Date Simplification.

Effective Date

The provision relating to the time for electing to be a subchapter S corporation applies to elections for taxable years beginning after December 31, 2013.

The provision relating to revocations applies to revocations after December 31, 2013.

B. Part 2 -- [Option 1] Partnerships

Overview

Partnerships are not subject to Federal income tax.⁵⁰ Instead, partners take into account items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership regardless of whether the income is distributed to the partners.⁵¹ A partner's basis of a partnership interest is adjusted to prevent double taxation when the partner later disposes of the partnership interest. A partner's basis includes the partner's capital contribution and the partner's share of partnership liabilities, is increased by the partner's distributive share of partnership income and gain, and is reduced by its distributive share of the partnership's deductible losses and nondeductible expenditures not properly chargeable to capital account as well as by partnership distributions.⁵² A partner's deduction for partnership losses is limited to the adjusted basis of the partnership interest.⁵³ To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.

Partners have significant flexibility to vary their respective shares of partnership income and other tax items. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect and meet regulatory requirements.

1. Repeal of rules relating to guaranteed payments (sec. 241(a) of the discussion draft and sec. 707(c) of the Code)

Present Law

Guaranteed payments made by a partnership generally refer to payments to a partner that are determined without regard to the income of the partnership and are for services or for the use of capital.⁵⁴ Guaranteed payments are distinct from a partnership distribution of income or capital,⁵⁵ and from payments by the partnership to a partner not acting in its capacity as a partner.⁵⁶

⁵⁰ Sec. 701.

⁵¹ Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership, such as to cover the tax liabilities of individual partners.

⁵² Sec. 705.

⁵³ Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership losses and deductions (sections 469 and 465) for partners that are individuals or closely held corporations.

⁵⁴ Sec. 707(c).

⁵⁵ Secs. 731 and 733.

⁵⁶ Sec. 707(a).

A distribution of income or capital reduces a partner's basis in the partnership and, to the extent an amount of money in excess of basis is distributed, gain is recognized. Payments by a partnership to a partner not acting in its capacity as a partner, such as making a loan to the partnership, are treated for tax purposes as if the partner was a third party.

Guaranteed payments are treated as payments made to one who is not a member of the partnership, but only for purposes of determining gross income and (subject to any capitalization requirement) the deduction for trade or business expenses. Thus, guaranteed payments generally are deductible by the partnership and includible in the income of the partner in the partner's taxable year in which, or with which, the partnership year ends.

According to the legislative history, the provision relating to guaranteed payments was enacted to address the treatment of payments to a partner during a taxable year when the payments for the year exceeded the partnership income for the year.⁵⁷ The provision has created a great deal of uncertainty, confusion, and controversy since its enactment.⁵⁸

Explanation of Provision

The provision repeals the special rules for inclusion in income by a partner, and deduction or capitalization by a partnership, of a guaranteed payment that is determined without regard to the income of the partnership and is made by a partnership to a partner for services, or for the use of capital (section 707(c)).⁵⁹ Thus, payments by a partnership to a partner are treated either as a payment to a partner not acting in its capacity as a partner under section 707(a), or as a distribution of partnership income or capital under section 731.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 2013.

⁵⁷ See. H. R. Rep. No 1337, 83d Cong., 2d Sess., 67-8 (1954), and S. Rep. No. 1622, 83d Cong., 2d Sess., 92 and 94 (1954).

⁵⁸ See, for example, L. Steinberg, "Fun and Games with Guaranteed Payments," 57 *Tax Lawyer* 533 (Winter 2004).

⁵⁹ Several commentators have recommended the repeal of section 707(c). See, for example, W. Brannan, *The Tax Club*, "Congressional Committee Report on the Subchapter K Reform Act of 1997" (Feb 19, 1997), reprinted at 76 *Tax Notes* 121 (April 7, 1997), and P. Postlewaite and J. Pennell, "JCT's Partnership Tax Proposals--Houston, We Have a Problem," 76 *Tax Notes* 527 (July 19, 1997).

2. Repeal of rules relating to payments made in liquidation of retiring or deceased partner (sec. 241(b) of the discussion draft and secs. 736 and 753 of the Code)

Present Law

In general

Section 736 provides rules for the treatment of payments made in the liquidation of a retiring or deceased partner's partnership interest. Payments are treated either as (1) a distributive share or guaranteed payment⁶⁰ or (2) payments in exchange for the partner's interest in partnership property.⁶¹

Payments for goodwill generally are amortized over a period of 15 years.⁶² However, under section 736(a), if a retiring general partner of a service partnership⁶³ agrees to treat payments for its share of partnership goodwill and unrealized receivables as ordinary income, the payments are deductible by the partnership (if the amount is determined without regard to the income of the partnership) or treated as a distributive share of partnership income (if determined with regard to the income of the partnership) thereby reducing the distributive share of the other partners (which is the equivalent to a deduction).

In the case of payments made in liquidation of a retiring or deceased partner's partnership interest to which section 736(a) does not apply, then under section 736(b), the payments are treated as made in exchange for the partnership interest. If the partner is a general partner in a service partnership, this treatment does not apply to unrealized accounts receivable and, except to the extent the partnership agreement provides otherwise, goodwill.

Income in respect of a decedent

Under present law, the receipt of income in respect of a decedent is includible in gross income,⁶⁴ and the general rule providing for a fair market value basis for property acquired from a decedent does not apply to property which consists of an item of income in respect of a decedent.⁶⁵ Section 753 provides that amounts includible in gross income of a successor in interest of a deceased partner under section 736(a) are considered income in respect of a

⁶⁰ Sec. 736(a).

⁶¹ Sec. 736(b).

⁶² Sec. 197.

⁶³ A service partnership refers to a partnership in which capital is not a material income-producing factor.

⁶⁴ Sec. 691.

⁶⁵ Sec. 1014(c).

decedent.⁶⁶ Courts have ruled that upon the death of a partner, the transferee's basis in its partnership interest is not adjusted for the portion of the partnership interest attributable to items representing income in respect of a decedent.⁶⁷

Explanation of Provision

The provision repeals section 736 and correspondingly repeals section 753 as obsolete. Thus, payments made to retiring partners and successors-in-interest to deceased partners are subject to the Federal tax rules generally applicable to the transaction, such as section 197 (relating to the treatment of goodwill), the provisions of subchapter D relating to payments under deferred compensation plans, and the generally applicable rules⁶⁸ governing income in respect of a decedent.⁶⁹

Effective Date

The provision applies to partnership taxable years beginning after December 31, 2013.

3. Mandatory adjustments to basis of partnership property in case of transfer of partnership interests (sec. 242 of the discussion draft and sec. 743 of the Code)

Present Law

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.⁷⁰

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner to the basis of partnership property. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.⁷¹ The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

⁶⁶ For a discussion of the interaction of this section with other provisions of subchapter K, see G. McBride, "Alice's Estate in the Wonderland of Subchapter K," *Tax Notes* 971 (Feb. 23, 2009).

⁶⁷ *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971).

⁶⁸ Secs. 691 and 1014(c).

⁶⁹ See P. Postlewaite and Rosenzweig, "Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part With Section 736?," 100 *Northwestern University Law Review* 1 (Special Issue, 2006) for a proposal to repeal section 736.

⁷⁰ Sec. 743(a).

⁷¹ Sec. 743(b).

A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than \$250,000 the fair market value of the partnership property.⁷² Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership property.⁷³ For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. The provision does not apply to a securitization partnership.

Explanation of Provision

The provision provides that the adjustments to the basis of partnership property in the case of a transfer of an interest in a partnership are required in all cases. The special rules for electing investment partnerships and securitization partnerships are repealed.

Effective Date

The provision applies to transfers after December 31, 2013.

4. Mandatory adjustments to basis of undistributed partnership property (sec. 243 of the discussion draft and sec. 734 of the Code)

Present Law

Treatment of distributee partners

Partners generally may receive distributions of partnership property without recognition of gain or loss.⁷⁴ In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).⁷⁵ In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).⁷⁶

⁷² Sec. 743(d).

⁷³ See sec. 743(e) (alternative rules for electing investment partnerships) and sec. 743(f) (exception for securitization partnerships).

⁷⁴ Sec. 731(a) and (b). Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceed a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and a loss is sustained (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737).

⁷⁵ Sec. 732(b).

⁷⁶ Sec. 732(a).

In the event that multiple properties are distributed by a partnership, allocation rules are provided for determining their bases in the distributee partner's hands. Under these rules, basis is first allocated to unrealized receivables and inventory items so that the properties bases equal their adjusted bases to the partnership before the distribution (or, if the total basis to be allocated is less than the partnership's bases, then the decrease is allocated in proportion to the respective amounts of unrealized depreciation to the extent thereof, and then to the extent the decrease has not been allocated, in proportion to their adjusted bases). No allocation may increase the basis of unrealized receivables or inventory items over their adjusted basis to the partnership before the distribution. To the extent basis is not allocated to unrealized receivables or inventory items, basis is allocated to other distributed property, first by allocating to each property the partnership's adjusted basis and then by increasing or decreasing that amount in order to have the adjusted bases of the properties equal the basis remaining after the allocation to unrealized receivables or inventory items. Basis decreases are allocated among properties in the manner described above; basis increases are allocated among properties first in proportion to their unrealized appreciation (to the extent of each property's unrealized appreciation) and then, to the extent of the increase that has not been allocated, in proportion to their fair market values.⁷⁷

Treatment of partnership

Adjustments to the basis of the partnership's undistributed properties generally are required if (and only if) there is a distribution with respect to which there is a substantial built-in loss or if an election under section 754 is in effect.⁷⁸ A substantial basis reduction means a downward adjustment of more than \$250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Adjustments are made by a partnership to increase or decrease the basis of remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).⁷⁹

Basis allocations among properties generally are allocated to reduce the difference between the fair market values and adjusted basis of partnership properties and by making

⁷⁷ If a partnership interest is transferred to a partner and the partnership has not elected to adjust the basis of partnership property, a special basis rule provides for the determination of the transferee partner's basis of properties that are later distributed by the partnership as if an election had been in effect (sec. 732(d)).

⁷⁸ Sec. 734(a).

⁷⁹ Section 734(b) provides for adjustments to the basis of partnership property in the case of distributions of property. Unlike section 743(b) (relating to transfers of partnership interests), there is no provision in section 734(b) that adjustments may be made only with respect to the transferee partner. This may result in the improper allocation of adjustments in the case of distributions not in complete liquidation of a partner's interest.

allocations to property of a like kind among properties which are (1) capital assets and property used in a trade or business and (2) other properties.⁸⁰

Present law provides an exception for securitization partnerships to the rules requiring partnership basis adjustments in the case of transfers of partnership interests and distributions of property to a partner.

Explanation of Provision

The provision requires a partnership to adjust the basis of partnership property in the case of a distribution to a partner. The adjustments are made so each remaining partner's net liquidation amount is unchanged. The net liquidation amount with respect to a partner is the net amount of gain or loss (if any) which would be taken into account by that partner under section 702 if all partnership property were sold at fair market value. Thus, under the provision, each remaining partner's share of net gain or loss from the sale of all partnership properties immediately after the distribution is the same as its share of net gain or loss if all the properties (including the distributed properties) had been sold by the partnership immediately before the distribution.

In the case of a distribution not in liquidation of the partnership, the partnership's adjustments with respect to the distributee partner take into account any gain recognized by the distributee partner on the distribution and any unrealized gain or loss which would be recognized by the distributee partner if it sold the properties for fair market value immediately after the distribution.

Basis is allocated among the remaining partnership properties in a manner similar to the allocation of bases among properties received by a distributee partner. Thus, negative adjustments are made first to property other than unrealized receivables and inventory items to the extent thereof. Positive adjustments are made only to property other than unrealized receivables and inventory property. In the case of a basis decrease, if there is insufficient adjusted basis in partnership property, each partner recognizes gain in the amount of the prevented decrease. In the case of a basis increase, if there is no partnership property whose basis may be increased, a loss is allowed to each partner in the amount of the prevented increase. Any gain or loss is treated as from the sale of the partnership interest.⁸¹

The exception for securitization partnerships is repealed.

⁸⁰ Sec. 755. Under section 755(c), however, no decrease in basis may be allocated to stock in a corporate partner (or related person), but must be allocated to other partnership property. Gain is recognized to the extent an amount required to be allocated to other partnership property exceeds the aggregate adjusted bases of the other property immediately before the distribution. This rule is intended to limit the ability of corporate partners to "duplicate tax deductions at no economic cost" through reducing the basis of stock in certain transactions. Senate Finance Committee Report to the "Jumpstart our Business Strength (JOBS) Act," S. Rep. 108-192, November 7, 2003, 127.

⁸¹ Section 751(b) continues to apply to partnership distributions.

The following examples illustrate the operation of this provision:

Example 1.—Assume A, B, and C form partnership ABC by contributing \$100 each. The partnership buys capital assets X, Y, and Z for \$80, \$100, and \$120 respectively. At a time when the fair market value of each asset is \$150, ABC distributes one of the assets to C in liquidation of its partnership interest. Immediately before the distribution, each partner would take into account \$50 gain if all the assets were sold by the partnership for their fair market value.

- a. If the partnership distributes property Y to C, no basis adjustment is required in order that A and B's share of the gain from the sale of X and Z remains at \$50 each.
- b. If the partnership distributes property X to C, the basis of the remaining properties is decreased by a total of \$20 (from \$220 to \$200) in order that A and B's share of the gain from the sale of X and Z remains at \$50 each. The decrease in each of the assets is in proportion to their respective adjusted bases.⁸² Thus, the basis of Y is reduced by $100/220$ times \$20, or \$9.09, and is now \$91.91. The basis of Z is reduced by $120/220$ times \$20, or \$10.91, and is now \$109.09.
- c. If the partnership distributes property Z to C, the basis of the remaining properties is increased by a total of \$20 (from \$180 to \$200) in order that A and B's share of the gain from the sale of X and Z remains at \$50 each. The increase in each of the assets is in proportion to their respective unrealized appreciation before the increase.⁸³ Thus, the basis of X is increased by $50/80$ times \$20, or \$12.50, and is now \$112.50. The basis of Y is increased by $30/80$ times \$20, or \$7.50, and is now \$127.50.

Example 2.—Assume A and B form partnership AB by each contributing \$100. AB buys capital asset X for \$60. At the time when X has increased in value to \$340, the partnership distributes \$120 cash to A. A's interest in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. A recognizes \$20 gain on the distribution (\$120 cash less \$100 basis in partnership interest). The partnership's basis in X is unchanged with respect to B since B's gain on the sale of X (\$140) immediately after the distribution is the same as its share of gain (\$140) if X had been sold immediately before the distribution. The partnership increases the basis of X with respect to A by the \$20 gain on the distribution to A so that A recognizes \$120 on the sale of X immediately after the distribution (in addition to the \$20 gain recognized on the cash distribution).⁸⁴

Example 3. Assume A and B form partnership AB by each contributing \$100. AB buys capital asset X for \$80 and capital asset Y for \$120. At a time when the value of X has increased to \$360 and the value of Y is still \$120, the partnership distributes Y to A. A's interest

⁸² Sec. 732(c)(3).

⁸³ Sec. 732(c)(2).

⁸⁴ Under present law, if a section 754 election is in effect, the partnership increases the basis of X by \$20, but the adjustment does not be apply solely with respect to A (present law sec. 734(b)(1)(A)).

in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. A's basis in Y is \$100 immediately after the distribution⁸⁵ so that if A immediately sells Y it will recognize gain of \$20. A's basis in its partnership interest is reduced to zero.⁸⁶ No partnership basis adjustment is required in X with respect to B since B's gain on the sale of X (\$140) immediately after the distribution is the same as its share of gain (\$140) if X were sold immediately before the distribution. The partnership increases the basis of X with respect to A by \$20, so that A recognizes \$120 on the sale of X immediately after the distribution (in addition to the \$20 gain which would be recognized if A sold Y immediately after the distribution).⁸⁷

Example 4.—Assume A and B form partnership AB by each contributing \$100. AB buys asset X for \$60 and asset Y for \$100. At the time when X has increased in value to \$320 and Y has increased in value to \$120, the partnership distributes Y to A. A's interest in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. A's basis in Y is \$100 so that if A immediately sold Y A would recognize gain of \$20. The basis in A's partnership interest is reduced to zero. The partnership's basis in X is decreased by \$10 with respect to B so that if Y is sold immediately after the distribution, B recognizes the same amount of gain (\$140) that B would have recognized if both assets had been sold immediately before the distribution. The basis of X is increased by \$10 with respect to A, so that A recognizes \$120 on the sale of X immediately after the distribution in addition to the \$20 gain which would be recognized if A sold Y immediately after the distribution.⁸⁸

Effective Date

The provision is effective for distributions after December 31, 2013.

5. Corresponding adjustment to basis of property held by lower-tier partnership in case of upper-tier partnership basis adjustments (sec. 244 of the discussion draft and new sec. 736 of the Code)

Present Law

The basis of property held by a partnership may be adjusted as a result of a distribution of other property by the partnership⁸⁹ or by the transfer of an interest in the partnership by sale,

⁸⁵ Sec. 732(a)(2).

⁸⁶ Sec. 733.

⁸⁷ Under present law, if a section 754 election is in effect, the partnership increases the basis of X by \$20, but the adjustment does not be apply solely with respect to A (present law sec. 734(b)(1)(B)).

⁸⁸ Under present law, if a section 754 election is in effect, the partnership makes no basis adjustment, since no gain or loss is recognized by A and the basis of property Y to A is the same as the basis to the partnership.

⁸⁹ Sec. 734.

exchange, or upon the death of a partner.⁹⁰ The basis of property distributed by a partnership also may be adjusted.⁹¹ Under present law, certain of these adjustments are not mandatory but other provisions of this bill require them to be mandatory. The property whose basis is adjusted may be an interest in another partnership.

Explanation of Provision

The provision supplies rules applicable to tiered partnerships in the event adjustments are required to the basis of partnership property.

If a distribution of partnership property requires a basis adjustment to an upper-tier partnership's interest in a lower tier partnership, then the lower-tier partnership is required to make a corresponding adjustment to the adjusted basis of its partnership property. Similarly, if a distribution of an interest in a lower-tier partnership to an upper-tier partnership (or a sale or exchange of an interest in an upper-tier partnership that holds an interest in a lower-tier partnership) results in an increase or a decrease in the basis of the partnership interest in the hands of the distributee partner, then a corresponding basis increase or decrease is required in the property of the lower-tier partnership. These corresponding adjustments are required through successive tiers of partnerships, and only with respect to the partnership's proportionate share of the adjusted basis of lower-tier partnership property.

An upper-tier partnership is required to furnish the lower-tier partnership (in such manner as the Secretary prescribes) the information necessary to enable the lower-tier partnership to make the basis adjustments.

Effective Date

The provision applies to distributions and transfers after December 31, 2013.

6. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss (sec. 245 of the discussion draft and sec. 704(d) of the Code)

Present Law

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its

⁹⁰ Sec. 743. For purposes of section 743, any distribution of an interest in a partnership is treated as an exchange. Sec. 761(e)(2).

⁹¹ Sec. 732.

partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).⁹²

A partner's basis in its partnership interest is increased by its distributive share of income (including tax exempt income) and is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account.⁹³ In the case of a charitable contribution, a partner's basis is reduced by the partner's distributive share of the adjusted basis of the contributed property.⁹⁴

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership.⁹⁵ Instead, a partner takes into account its distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.⁹⁶

Treasury regulations provide that “[i]f the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss.”⁹⁷ These regulations exclude from the 704(d) limitation the items specified in section 702(a)(4) (charitable contributions) and 702(a)(6) (foreign taxes paid or accrued).

The IRS has taken the position in a private letter ruling that the section 704(d) loss limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.⁹⁸

⁹² Sec. 704(d) and Treas. Reg. 1.704-1(d)(1).

⁹³ Sec. 705(a).

⁹⁴ Rev. Rul. 96-11, 1996-1 C. B. 140.

⁹⁵ Sec. 703(a)(2)(B) and (C). In addition, section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

⁹⁶ Sec. 702.

⁹⁷ Treas. Reg. sec. 1.704-1(d)(2).

⁹⁸ PLR 8405084. And see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4th Edition (2011), paragraph 11.05[1][b], pp. 11-214 (noting that the “failure to include charitable contributions in the § 704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease.”).

While the regulations relating to the section 704(d) loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.⁹⁹

Section 1366(d) limits the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder's basis in stock and debt of the corporation. For purposes of this limitation, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account by reason of the last sentence of section 1366(a)(1).¹⁰⁰

Explanation of Provision

The provision modifies the section 704(d) loss limitation rule to provide that a partner's distributive share of items that are not deductible in computing the partnership's taxable income, and not properly chargeable to capital account, are allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership taxable year in which the expenditure occurs. Thus, the section 704(d) loss limitation applies to a partner's distributive share of charitable contributions and foreign taxes.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 2013.

7. Revisions related to unrealized receivables and inventory items (sec. 246 of the discussion draft and sec. 751 of the Code)

Present Law

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset.¹⁰¹ However, gain is treated as ordinary income on the sale or exchange of a partnership interest of a partnership holding unrealized receivables or inventory items to the extent thereof.¹⁰²

Certain distributions are treated as sales or exchanges where a partnership holds unrealized receivables or substantially appreciated inventory.¹⁰³ To the extent a partner receives

⁹⁹ Sec. 901.

¹⁰⁰ In connection with the application of the section 1366(d) limitation to charitable contributions, section 1366(d)(4) provides a special rule prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation. Under a related rule, the shareholder's basis in his interest is decreased by the basis (rather than the fair market value) of appreciated property by reason of a charitable contribution of the property by the S corporation (temporarily through 2013) (sec. 1367(a)(2)).

¹⁰¹ Sec. 741.

¹⁰² The last sentence of section 741 and sec. 751(a).

¹⁰³ Sec. 751(b).

in a distribution any partnership property that is unrealized receivables or substantially appreciated inventory items in exchange for all or a part of his interest in other partnership property (including money), or vice versa, the transaction is treated under regulations as a sale or exchange of the property between the distributee partner and the partnership (as constituted after the distribution). This treatment is provided to prevent reallocation among the partners of ordinary income and capital gain.

Unrealized receivables generally includes amounts for the right to payment for goods sold (otherwise treated as ordinary income) and services, to the extent not previously included in income. In addition, for purposes of sections 731 (relating to gain or loss on distributions), 732 (relating to basis of distributed property other than money), and 741 (relating to recognition and character of gain or loss on sale or exchange of partnership interest), but not for purposes of section 735 (relating to character of gain or loss on disposition of distributed property), unrealized receivables includes numerous listed properties to the extent ordinary income would arise if the properties were sold at their fair market value.

Treasury regulations¹⁰⁴ provide examples that analyze shifts in the partnership's and the distributee partner's shares of the value of partnership assets, but do not take account of shifts in the partnership's and the distributee partner's shares of ordinary income and gain.

Explanation of Provision

The provision eliminates the substantial appreciation limitation with respect to inventory items of a partnership in the case of distributions treated as sales or exchanges under section 751(b). Thus, section 751(b) applies to distributions by partnerships holding inventory items, whether or not substantially appreciated.

The Secretary of the Treasury is required to revise regulations issued under section 751(b) to take into account the partner's share of income and gain rather than the partner's share of partnership assets.¹⁰⁵

The provision simplifies the definition of an unrealized receivable by providing that the term includes any property other than an inventory item but only to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value.

Effective Date

The provision relating to the repeal of the substantial appreciation requirement applies to distributions after December 31, 2013.

¹⁰⁴ Treas. Reg. sec. 1.751-1. Examples are provided in Treas. Reg. sec. 1.751-1(g).

¹⁰⁵ IRS Notice 2006-14 (Feb. 21, 2006) IRB 2006-8 requested comments on alternative approaches to the current section 751(b) regulations to achieve the purposes of the provision that would provide greater simplicity.

The provision relating to the simplification of the definition of unrealized receivables applies to partnership taxable years beginning after December 31, 2013.

8. Repeal of time limitation on taxing precontribution gain (sec. 247 of the discussion draft and secs. 704(c) and 737 of the Code)

Present Law

If a partner contributes appreciated property to a partnership, no gain or loss is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain or loss is reflected in the difference between the partner's capital account and its basis in its partnership interest ("book/tax differential"). Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.¹⁰⁶

If the property is subsequently distributed to another partner within seven years of the contribution, the contributing partner generally recognizes gain or loss from the sale of the property in an amount equal to the gain or loss which would have been allocated to the partner by reason of the variation between basis and value at the time of contribution as if the property had been sold for its fair market value at the time of the distribution.¹⁰⁷

Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within seven years after the contribution of the appreciated property.¹⁰⁸

Explanation of Provision

The provision repeals the limitation on the time period in which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the provision, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, regardless of when the distribution occurs.

Effective Date

The provision applies to property contributed to a partnership after December 31, 2013.

¹⁰⁶ Sec. 704(c)(1)(A).

¹⁰⁷ Sec. 704(c)(1)(B).

¹⁰⁸ Sec. 737.

III. SUBTITLE C -- [OPTION 2] UNIFIED RULES FOR PASSTHROUGHS

A. Present Law

1. Partnerships

Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.¹⁰⁹ Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).¹¹⁰ A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.¹¹¹ To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to capital account, and (2) any partnership distributions.¹¹²

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

Limited liability companies

In the last 35 years, States have enacted laws providing for another form of entity, the limited liability company ("LLC").¹¹³ LLCs are neither partnerships nor corporations under

¹⁰⁹ Sec. 701.

¹¹⁰ Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership to cover the tax liabilities of individual partners.

¹¹¹ Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level passive income from other investments.

¹¹² Sec. 705.

¹¹³ The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

applicable State law, but they generally provide limited liability to their owners for obligations of the business. LLCs generally are treated as partnerships for Federal income tax purposes, unless an election is made to be treated as a corporation. Under regulations promulgated in 1996, any domestic unincorporated entity with two or more members that is not publicly traded is treated as a partnership under the default rules but may elect to be treated as a corporation for Federal income tax purposes, and any single-member unincorporated entity is disregarded (*i.e.*, treated as not separate from its owner)¹¹⁴ for Federal income tax purposes under the default rules (though it may elect to be treated as a corporation).¹¹⁵ These regulations, known as the check-the-box regulations, were a response, in part, to the growth of LLCs.¹¹⁶

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.¹¹⁷ For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).¹¹⁸

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.¹¹⁹ However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940¹²⁰ as a management company or unit investment trust.¹²¹

¹¹⁴ Thus, if the single member is an individual, such a disregarded LLC is treated as a sole proprietorship. If the single member is a corporation, the LLC is treated as a division or branch.

¹¹⁵ Treas. Reg. sec. 301.7701-3.

¹¹⁶ More recently, some State law has provided for so-called series LLCs (the first was Delaware in 1996, Del. Code Ann. Title 6, section 18-216). Treasury regulations have been proposed that address the tax treatment of series LLCs and domestic cell companies created under applicable State law (as well as certain foreign series or cells). The proposed regulations set forth criteria for determining whether the series or cell is treated as an entity for Federal tax purposes. See REG-119921-09, September 14, 2010. The proposed regulations define a series as “a segregated group of assets and liabilities that is established pursuant to a series statute...by agreement of a series organization....” Prop. Treas. Reg. 301.7701-1(a)(5)(C).

¹¹⁷ Sec. 7704(a). The reasons for change stated by the Ways and Means Committee when the provision was enacted provide in part: “[t]he recent proliferation of publicly traded partnerships has come to the committee’s attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base.” H.R. Rep. 100-391, Omnibus Reconciliation Act of 1987, October 26, 1987, p. 1065.

¹¹⁸ Sec. 7704(b).

¹¹⁹ Sec. 7704(c)(2).

¹²⁰ Pub. L. No. 76-768 (1940).

¹²¹ Sec. 7704(c)(3).

Section 7704(d) defines qualifying income to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gain from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts.

2. S corporations

In general

An S corporation provides the Federal income tax advantage of passthrough treatment while retaining the nontax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders generally are treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. To make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity and number of its shareholders.

Limitations on number and type of shareholders and class of stock

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.¹²² Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.¹²³ Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership). Certain corporations may not elect S corporation status including financial institutions using the reserve method of accounting for bad debts and insurance companies subject to tax under subchapter L.¹²⁴

¹²² Sec. 1361. For this purpose, a husband and wife and all members of a family (and their estates) are treated as one shareholder. Under this rule, members of a family means a common ancestor and any lineal descendant up to six generations removed, and the spouse or former spouse of the common ancestor or lineal descendant. Sec. 1361(c)(1).

¹²³ Sec. 1362.

¹²⁴ Sec. 1361(b)(2).

Passthrough of income and losses to S corporation shareholders

For Federal income tax purposes, an S corporation generally is not subject to tax at the corporate level.¹²⁵ Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders (under the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the S corporation to such shareholder.¹²⁶ To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased (in the case of stock) by the shareholder's share of the S corporation's income and contributions to capital.¹²⁷

S corporations that were previously C corporations

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the S corporation was previously a C corporation and generally are intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.¹²⁸ Second, if a C corporation elects to be an S corporation (or transfers assets to an S corporation in a carryover basis transaction), certain net built-in gains that are attributable to the period in which it was a C corporation, and that are recognized during the first 10 years (currently shortened to five years under a temporary provision that expires after 2013) in which the former C corporation is an S corporation, are subject to corporate-level tax.¹²⁹

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation, or unless

¹²⁵ Secs. 1363 and 1366.

¹²⁶ In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by S corporation deductions (sections 465 and 469).

¹²⁷ Sec. 1367.

¹²⁸ Sec. 1375. Subchapter C earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated. Sec. 1362(d)(3).

¹²⁹ Sec. 1374(d). The five-year period is temporary, for taxable years beginning in 2012 and 2013. The period was seven years for taxable years beginning in 2009 and 2010, and five years for taxable years beginning in 2011.

the S corporation was formerly a C corporation and has undistributed earnings and profits.¹³⁰ To the extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

3. Comparison of features of partnerships and S corporations

Notwithstanding that they both provide for passthrough treatment, there are several significant Federal income tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder's basis of an interest in an S corporation, whereas a partner's share of partnership-level debt generally is taken into account. However, unlike a partner in a partnership, an S corporation shareholder's limitation on corporate deductions looks to the shareholder's adjusted basis in both S corporation stock and indebtedness of the S corporation to such shareholder. Thus, S corporation shareholders might be able to substitute shareholder-level debt for entity-level borrowing and contribute or re-lend such amounts to the S corporation to provide basis (in the shareholder's stock or debt) against which entity losses may be taken.¹³¹

Further, S corporations may have only one class of stock and, thus, do not offer the same flexibility as partnerships to allocate income and losses among investors. In addition, if a tax-exempt entity (including any individual retirement account or qualified retirement plan) is an equity investor in a partnership, its share of business income of the partnership is subject to unrelated business income tax. An S corporation likewise generally is not permitted to have a tax-exempt shareholder that is not subject to unrelated business income tax on S corporation income, except that an employee stock ownership plan ("ESOP") is permitted to be a shareholder in an S corporation without unrelated business income tax.¹³²

An S corporation, unlike a partnership, permits a C corporation to convert to a passthrough form without immediate recognition of gain at either the corporate or the shareholder level. Since 1986, the liquidation of a C corporation has required the corporation to recognize gain on its assets. Conversion of a C corporation to a partnership is treated as a liquidation of the C corporation. However, conversion of a C corporation to an S corporation is achieved through electing S status without immediate tax consequences, rather than by liquidating the corporation in a taxable transaction. Certain built-in gain and built-in income items of the C corporation that elects S corporation status remain subject to C corporation tax if recognized within 10 years (currently shortened to five years under a temporary provision that expires after 2013)¹³³ after the conversion. Thus, if a C corporation can satisfy the limit on the

¹³⁰ Sec. 1368.

¹³¹ Proposed regulations relating to shareholder loans to S corporations refer to "bona fide indebtedness of the S corporation that runs directly to the shareholder," and in that connection state, "[w]hether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances." Prop. Treas. Reg. sec. 1.1366-2(a)(2)(i).

¹³² Sec. 512(e)(3).

¹³³ The period was seven years for taxable years beginning in 2009 and 2010, and five years for taxable years beginning in 2011, 2012 and 2013.

number and type of shareholders, the single class of stock requirement, and other requirements for S corporation status, conversion of a C corporation to the S corporation passthrough form is not taxable, and all post-conversion income and appreciation of assets in the entity are subject only to shareholder level tax.

Table 1 lists the principal differences in the taxation of the two types of entities and their owners.

Table 1.—Principal Differences in Taxation of Partnerships and S Corporations

Item	Partnerships	S Corporations
Maximum number of equity interests	No maximum number. Partnerships with over 100 partners may elect a special passthrough regime. ¹³⁴	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.
Classes of equity interests	No limitation.	One class of stock. Voting rights are disregarded in making this determination.
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs.
Eligible shareholders	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.
Foreign taxpayers	Eligible to be a partner; certain income subject to withholding tax.	Ineligible to be a shareholder.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.

¹³⁴ See secs. 771-777 and 6240-6255 for treatment of electing large partnerships.

Item	Partnerships	S Corporations
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.
Contributions of property to entity	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special rules allocating built-in gain or loss to contributor.
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-through provision; no adjustments to basis of corporate property.
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10-year period after election effective (a current temporary provision shortened the period to 5-years for 2011, 2012, and 2013; special rules

Item	Partnerships	S Corporations
		in 2009 and 2010 also shortened the period); distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.
Mergers, etc. with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.
Wholly owned corporation	Corporation treated as separate entity.	Wholly owned subsidiary corporation may elect to be treated as part of parent S corporation.
Application of employment (OASDI and HI) taxes	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation to a shareholder-employee are wages; no amounts are net earnings from self-employment.

B. Explanation of Provisions

1. Unified rules for passthroughs (sec. 231 of the discussion draft)

The provision repeals subchapters K and S in Chapter 1 of the Code. The provision inserts new subchapter K.

2. Tax treatment of passthrough (sec. 231 of the discussion draft and new sec. 701 of the Code)

The provision exempts a passthrough from entity level tax. However, the passthrough is required to withhold on an owner's distributive share of passthrough income.¹³⁵

3. Passthrough defined (sec. 231 of the discussion draft and new sec. 702 of the Code)

For purposes of new subchapter K, the provision defines a passthrough as any partnership (within the meaning of section 761(a) before its repeal by the Tax Reform Act of 2013) and any passthrough corporation.¹³⁶

Consistent with present law section 761(a), the provision provides an exception for unincorporated organizations. Under regulations, the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from all or part of new subchapter K. An unincorporated organization is an organization that is used: (1) for investment purposes only and not for the active conduct of a trade or business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities. In addition, the income of the members of such unincorporated organization must be able to be adequately determined without the computation of passthrough items.

Special rules similar to present law section 761(f) are provided in the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year. In such instances, the joint venture is not treated as a passthrough; rather, the items of income, gain, loss, deduction, and credit are divided between spouses in accordance with their respective interests in the venture. Each spouse takes into account their respective share of such items as if they were attributable to a trade or business conducted by each spouse as a sole proprietor. The provision defines a qualified joint venture as any joint venture involving the conduct of a trade or business if: (1) the only members of such joint venture are a husband and wife, (2) both spouses

¹³⁵ For a discussion of the provisions concerning withholding on a distributive share of passthrough income, see *infra* III.B.33, Withholding of tax on owner's distributive share of income.

¹³⁶ For a discussion of passthrough corporations, see new section 703 at *infra* III.B.4, Passthrough corporation.

materially participate¹³⁷ in such trade or business, and (3) both spouses elect the application of this subsection.

4. Passthrough corporation (sec. 231 of the discussion draft and new sec. 703 of the Code)

In general

The provision defines a passthrough corporation as any corporation (except those discussed below) for which an election is in effect under this subsection for the taxable year. In general, an election under this subsection applies to the taxable year in which the election is made and all subsequent years, unless revoked with the consent of the Secretary.

An election under this subsection for any taxable year must be made not later than the due date (including extensions) for filing a timely filed return for such taxable year. C corporations that elected to be taxed under subchapter S before its repeal are treated as having made this election for the corporation's first taxable year after December 31, 2013, unless an election is made not to be treated as a passthrough corporation.

Exceptions to definition

A passthrough corporation does not include any corporation that is: (1) publicly traded; (2) a financial institution that uses the reserve method of accounting for bad debts; (3) an insurance company subject to tax under subchapter L; or (4) a DISC or former DISC. Thus, a passthrough corporation does not include any publicly traded corporations or any ineligible corporations under present law subchapter S.¹³⁸

For purposes of this exception, a corporation is treated as publicly traded if: (1) shares of such corporation are traded on any established securities market (within the meaning of section 1273(b) or 7704(b))¹³⁹ or (2) shares of such corporation are readily tradable on a secondary market (or the substantial equivalent thereof).

Under present law, an established securities market includes a national securities exchange registered under section 6 of the Securities and Exchange Act of 1934,¹⁴⁰ a national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 because of the limited volume of transactions, a foreign securities exchange or foreign board of trade, a regional or local exchange, an interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934, and an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

¹³⁷ Material participation refers to the definition in section 469(h) without regard to paragraph (5) thereof.

¹³⁸ Sec. 1361(b)(2).

¹³⁹ See 1.1273-2(f) and 1.7704-1(b) for the definition of an established securities market.

¹⁴⁰ 15 USC 78f.

Property also is considered traded on an established market if it is market traded property or property appearing on a quotation medium. Market traded property is property of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market. Property appears on a quotation medium if it appears on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers, or traders, or actual prices of recent sales transactions.

The definition of publicly traded in this provision is intended to be broader than the definitions under present law.

5. Computation of passthrough items (sec. 231 of the discussion draft and new sec. 704 of the Code)

This provision provides that taxable income of the passthrough and each of the passthrough items (*i.e.*, items of income, gain, loss, deduction, or credit of the passthrough) are computed in the same manner as in the case of an individual. However, the following deductions are not allowed to the passthrough: (1) the deductions for personal exemptions provided in section 151; (2) the deduction for taxes provided in section 164(a), with respect to taxes described in section 901, paid or accrued to foreign countries and to possessions of the United States; (3) the deduction for charitable contributions provided in section 170; (4) the net operating loss deduction provided in section 172; (5) the additional itemized deductions for individuals provided in part VII of subchapter B; and (6) the deduction for depletion under section 611 with respect to oil and gas wells. Further, if the passthrough (or any predecessor) was a C corporation for any of the three immediately preceding taxable years, section 291 (special rules relating to corporate preference items) applies.

Elections affecting the computation of passthrough items are made by the passthrough with one exception; elections under section 901 (relating to taxes of foreign countries and possessions of the United States) are made by each owner separately.

6. Pass-thru of items to owners (sec. 231 of the discussion draft and new sec. 711 of the Code)

Under the provision, each item of income (including tax-exempt income), gain, loss, deduction (including non-deductible expenditures), or credit of the passthrough is taken into account in computing the tax of the owner regardless of whether the income is distributed to the owner.¹⁴¹ The owner takes into account the character of any passthrough item as if the item were realized or incurred by the passthrough (based on the passthrough's method of accounting).¹⁴² To the extent provided in regulations or other guidance, the passthrough must provide each owner with necessary information with respect to the characteristics of the owner's distributive share of passthrough items.

¹⁴¹ New sec. 711(a).

¹⁴² New sec. 711(b).

7. Determination of owner's distributive share (sec. 231 of the discussion draft and new sec. 712 of the Code)

Determining the owner's distributive share

Under the provision, an owner's distributive share¹⁴³ generally is determined by the ownership agreement. However, the distributive share must be consistent with the owner's economic interest in the passthrough (determined by taking into account all facts and circumstances). If the distributive share under the ownership agreement is inconsistent with the owner's economic interest in the passthrough, the distributive share of each owner is adjusted accordingly. If the ownership agreement does not provide for an owner's distributive share, the distributive share is determined according to the owner's economic interests in the passthrough.

Under the provision, a restriction is placed on the ability to provide different distributive shares of passthrough items within a particular category to the same owner (except for those differences attributable to the rules for contributed property¹⁴⁴ and unrealized receivables and inventory items¹⁴⁵). An owner is restricted to a single distributive share (when expressed as a percentage) of all passthrough items within each of the following separate categories: (1) ordinary items; (2) capital gain rate items; and (3) tax credits.

Capital gain rate items means any passthrough item of gain or loss from the sale or exchange of a capital asset and any qualified dividend income (as defined in section 1(h)(11)). Ordinary items means any passthrough item which is not a capital gain rate item, a tax credit, or a foreign tax. Tax credits, other than an owner's distributive share of foreign taxes, are a separate category of passthrough items. An owner's distributive share of foreign taxes (described in new section 711(a)(3)) must follow the owner's distributive share of the passthrough items on which the foreign tax was imposed.

Thus, under the provision, if an owner's distributive share is 50 percent of the rental income of the passthrough, the owner's distributive share must also include 50 percent of every other passthrough item in the ordinary category (including, for example, 50 percent of total depreciation expense, 50 percent of total interest income, 50 percent of total charitable contributions, *etc.*). In addition, if the same owner's distributive share is 25 percent of the net long term capital gain of the passthrough, that owner must also receive a 25 percent distributive share of every passthrough item in the capital gain rate category (*e.g.*, 25 percent of any net short term capital loss and 25 percent of any qualified dividend income).

¹⁴³ See new sec. 761 for the definition of "distributive share."

¹⁴⁴ New sec. 712(d).

¹⁴⁵ New sec. 751(b).

The Secretary is directed to prescribe regulations or other guidance which prevent the avoidance of the purpose of the restriction on distributive shares, including rules for application of the restriction on distributive shares with respect to passthroughs under common control.¹⁴⁶

Example.—Assume passthrough AB has 2 owners, A and B. The passthrough has the following items related to its leasing activities: \$100 of rental income and depreciation expense of \$50, for a net income of \$50 from the leasing activity. The passthrough also receives \$50 royalty income. A's economic interest in the passthrough is with respect to the leasing activity, while B's economic interest in the passthrough is with respect to the intellectual property giving rise to the royalty income. Thus, of the \$100 total passthrough net income, A and B each have \$50, or 50 percent each. For purposes of applying this section, A's and B's distributive shares of \$50 are each comprised of 50 percent of each ordinary passthrough item, specifically, \$50 of rental income (50 percent of the \$100 of rental income), \$25 depreciation expense (50 percent of the \$50 depreciation expense), and \$25 royalty income (50 percent of the \$50 royalty income).

Contributed property

When an owner contributes appreciated property to a passthrough, no gain or loss is recognized to the contributing owner at the time of the contribution. The contributing owner's basis in its passthrough interest is increased by the basis of the contributed property at the time of the contribution. The precontribution gain or loss is reflected in the owner's basis in its passthrough interest. Income, gain, loss, and deduction with respect to the contributed property must be shared among the owners so as to take account of the variation between the basis of the property to the passthrough and its fair market value at the time of contribution.¹⁴⁷

If contributed property is distributed by the passthrough to an owner other than the contributing owner, the contributing owner recognizes any precontribution gain or loss that would be recognized as if the contributed property were sold for its fair market value at the time of distribution under this provision.¹⁴⁸ The character of such gain or loss is determined by reference to the character of the gain or loss that would have occurred if the property were sold by the passthrough to the distributee owner. The basis of the contributing owner's passthrough interest and the adjusted basis of the distributed property are adjusted to reflect any recognized precontribution gain or loss.

A built-in loss may be taken into account only by the contributing owner and not by other owners. Except as provided in regulations, in determining the amount of items allocated to owners other than the contributing owner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing owner's passthrough

¹⁴⁶ For this purpose, common control refers to taxpayers treated as a single employer under section 52(a) or (b) or section 414(m) or (o).

¹⁴⁷ New sec. 712(d)(1)(A).

¹⁴⁸ Precontribution gain is recognized upon the distribution of contributed property to another owner under new section 712(d)(1)(A) and new section 731(b)(2).

interest is transferred or liquidated, the passthrough's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.

Under regulations prescribed by the Secretary, similar rules apply to contributions of accounts payable and other accrued but unpaid items by a cash-method owner. In addition, any successor to the contributing owner is treated as the contributing owner for purposes of this provision.

The provision for contributed property is similar to the present law provision for partnerships under section 704(c). However, in contrast with present law for partnerships, the provision provides no limitation on the time period in which an owner must recognize pre-contribution gain with respect to property contributed to a passthrough. Thus, under the provision, an owner that contributes appreciated property to a passthrough generally recognizes pre-contribution gain in the event that the passthrough distributes the contributed property to another owner, or distributes to the contributing owner other property whose value exceeds that owner's basis in its passthrough interest, regardless of when the distribution occurs.

Limitation on allowance of losses

As under present law for partnerships, an owner's distributive share of passthrough loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the owner's interest in the passthrough at the end of the passthrough taxable year in which the loss occurred.¹⁴⁹ Any disallowed loss is allowable as a deduction at the end of the first succeeding passthrough taxable year, and subsequent taxable years, to the extent that the owner's adjusted basis in its passthrough interest at the end of any such year exceeds zero (before reduction by the loss for the year). In determining the amount of loss, the owner's distributive share of charitable contributions and foreign taxes is taken into account.¹⁵⁰

Family passthroughs

In the case of a passthrough interest created by a purchase or gift from a family member (*i.e.*, the donor), the donee owner's distributive share as determined by the ownership agreement is subject to adjustment to the extent that (1) the donee owner's distributive share is determined without allowance of reasonable compensation for services the donor provides to the passthrough; or (2) the donee owner's distributive share attributable to the donee owner's capital is proportionately greater than the donor's distributive share attributable to the donor's capital. However, the donee's distributive share is not diminished because of absence due to military service.

¹⁴⁹ In addition, passive loss and at-risk limitations limit the extent to which certain kinds of income can be offset by passthrough deductions (section 469 and 465).

¹⁵⁰ See the explanation of sec. 245 of the discussion draft at *infra* II.B.6, Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss, for more information regarding the application of the loss limitation to an owner's distributive share of charitable contributions and foreign taxes.

For this purpose, a family member includes only the spouse, ancestors, and lineal descendants of an individual, as well as any trusts for the primary benefit of such persons. An individual is recognized as a passthrough owner for purposes of this subtitle only if the individual's capital interest in the passthrough was derived by purchase or gift from a family member. Further, these rules only apply to passthrough interests where capital is a material income-producing factor in the passthrough. In contrast to present law for partnerships, the family passthrough rules only apply to individual taxpayers and only apply to passthrough interests acquired from a family member.

8. Determination of owner's basis in passthrough interest (sec. 231 of the discussion draft and new sec. 713 of the Code)

An owner's basis in its passthrough interest is the basis determined under new section 722 (related to contributed property) or new section 742 (related to basis of transferee owner's passthrough interest). An owner's basis is increased by the owner's distributive share of passthrough items of income and gain, tax-exempt income, and the excess of depletion deductions over the basis in property subject to depletion. An owner's basis is decreased by distributions to the owner (as determined under new section 733), the owner's distributive share of passthrough items of loss and deduction (including non-deductible expenditures), and the owner's distributive share of oil and gas depletion deductions to the extent such deductions do not exceed the owner's share of the basis of the passthrough's oil and gas properties.

9. Nonrecognition of gain or loss on contribution (sec. 231 of the discussion draft and new sec. 721 of the Code)

No gain or loss generally is recognized to a passthrough or to any of its owners upon a contribution of property to the passthrough in exchange for a passthrough interest.

Exceptions to this rule of nonrecognition apply in the case of (1) a passthrough that is (or, were it a corporation would be) treated as an investment company under section 351, (2) as provided in regulations, the transfer of property to a passthrough if such gain, when recognized, will be includible in the gross income of a person other than a United States person, or (3) except as provided in regulations, the transfer of intangibles to a passthrough.

The provision is similar to the present law section 721 rule providing generally for no gain or loss recognition by a partnership or any of its partners on contribution of property in exchange for a partnership interest. Unlike the control requirement of the present law section 351 rule providing that no gain or loss is generally recognized to an S corporation, or to any of its shareholders upon a contribution of property to the S corporation in exchange for stock, the provision does not require that the contributing person or persons be in control of the passthrough immediately after the exchange.

10. Basis with respect to contributed property (sec. 231 of the discussion draft and new sec. 722 of the Code)

The basis of an owner's interest acquired in exchange for a contribution of property, including money, to a passthrough is the amount of money and the adjusted basis of the property

to the contributing owner at the time of the contribution, increased by the amount of gain (if any) recognized by the contributing owner in connection with the investment company rules.

The passthrough's basis in property contributed to a passthrough by an owner is the adjusted basis of the property to the contributing owner at the time of the contribution, increased by the amount of gain (if any) recognized by the contributing owner in connection with the investment company rules as provided in new section 721(b).

This rule generally is similar to the basis rules of present law section 721, 722, 358, and 362 relating to contributions of property to partnerships and S corporations, which provide generally for a substituted basis for the partner's or S corporation shareholder's interest and a carryover basis for the partnership or S corporation in the contributed property.

11. Character of gain or loss on contributed unrealized receivables, inventory items and capital loss property (sec. 231 of the discussion draft and new sec. 723 of the Code)

If a passthrough disposes of property that was contributed by an owner and that was an unrealized receivable or inventory in the owner's hands immediately before the contribution, then any gain or loss recognized by the passthrough on the disposition is treated as ordinary income or loss.

If a passthrough disposes of property that was contributed by an owner and that was a capital asset in the owner's hands immediately before the contribution, then any loss recognized by the passthrough on the disposition is treated as a capital loss to the extent that the owner's adjusted basis of the property exceeded its fair market value immediately before the property was contributed to the passthrough.

For this purpose, an unrealized receivable is defined as in new section 751, applied as if the owner were the passthrough. An inventory item is defined as in new section 751, but without regard to the section 1231 one-year holding period. Thus, property that would otherwise be eligible for section 1231 capital gain treatment is not treated as inventory for purposes of this provision solely because it has been held for less than a year.

If property subject to the provision is disposed of in a nonrecognition transaction, the same tax treatment applies to any substituted basis property resulting from the nonrecognition transaction (or a series of nonrecognition transactions). An exception to this rule for substituted basis property provides that the tax treatment of the provision does not apply to substituted basis property that is stock in a C corporation received in a section 351 exchange.

The provision generally is similar to the provision of present law section 724 governing the character of gain or loss on unrealized receivables, inventory items (but without the five-year limitation), and capital loss property contributed to a partnership.

12. Extent of gain or loss on distribution (sec. 231 of the discussion draft and new sec. 731 of the Code)

Treatment of owner on distribution

In the case of a distribution by a passthrough to an owner, the fair market value of property, and the amount of money, distributed is not included in the owner's gross income to the extent these amounts do not exceed the adjusted basis of the owner's passthrough interest immediately before the distribution.

If the fair market value of property, and the amount of money, distributed exceeds the adjusted basis of the owner's passthrough interest, then the excess is treated as gain from the sale or exchange of the owner's passthrough interest. Thus, as provided in new section 741, such gain generally is considered as gain from the sale or exchange of a capital asset, except as provided in new section 723 (relating to character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property) or new section 751 (relating to unrealized receivables or inventory items).

In the event of the liquidation of the owner's passthrough interest, the owner recognizes gain to the extent the fair market value of property, and the amount of money, distributed exceeds the adjusted basis of the owner's passthrough interest. In addition, a loss on the termination of the owner's passthrough interest generally is recognized and is treated as a loss from the sale or exchange of the passthrough interest.¹⁵¹ However, notwithstanding this general rule, no loss is recognized unless the termination is of all direct and indirect interests of the owner in the passthrough. In the event the termination of the owner's interest in the passthrough is not complete, any loss not recognized as a result is suspended and is recognized on the termination of all the owner's direct and indirect interests in the passthrough.

Passthrough recognizes gain on distribution

On the distribution of property other than money, for purposes of determining gain recognized by the passthrough, the passthrough is treated as having sold the distributed property for its fair market value immediately before the distribution of the property to the owner. No loss is recognized by the passthrough on a distribution. Any gain recognized by the passthrough on the property distribution is shared among the passthrough owners in accordance with their distributive shares as provided in new section 712.

For example, if a passthrough distributes to an owner property with a fair market value of \$100 and an adjusted basis to the passthrough of \$80, the passthrough has a gain of \$20 that is shared among the owners in accordance with their distributive shares.

¹⁵¹ Such loss generally is considered as loss from the sale or exchange of a capital asset, except as provided in new section 723 (relating to character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property) or new section 751 (relating to unrealized receivables or inventory items).

Other rules

The provision does not apply to the extent otherwise provided under the rules of new section 712(d) (relating to contributed property) and new section 751 (relating to unrealized receivables and inventory items). For example, the provision does not apply to the extent new section 712(d) otherwise requires an owner to recognize precontribution loss with respect to contributed built-in loss property in the event of a distribution, or new section 751(b) otherwise requires an owner or owners to recognize gain or ordinary income upon a distribution. This rule also serves as an anti-double-counting rule in that the same items of income, gain or loss are included in income no more than once.

The treatment of distributions by passthrough corporations with accumulated earnings and profits is governed by new section 772.

13. Basis of distributed property other than money (sec. 231 of the discussion draft and new sec. 732 of the Code)

The basis of property (other than money) distributed by a passthrough to an owner is the sum of (1) the lesser of (a) the passthrough's adjusted basis in the property immediately before the distribution but after being increased by any gain recognized by the passthrough on the distribution or (b) the owner's adjusted basis in its passthrough interest immediately before the distribution, and (2) any gain recognized by the owner by reason of the distribution to the extent the amount of money or the fair market value of property distributed exceeds the owner's predistribution basis in its passthrough interest.

This rule determines the basis following distribution for either gain or loss property. In the case of loss property, the basis of the property in the hands of the distributee cannot exceed the distributee's basis in its passthrough interest immediately before the distribution. This rule provides for adjustments to the basis of distributed property attributable both to any gain recognized by the passthrough on distribution under new section 731(b), and to any gain recognized by the owner on the distribution under new section 731(a)(2).

14. Basis of distributee owner's passthrough interest (sec. 231 of the discussion draft and new sec. 733 of the Code)

In the case of a distribution by a passthrough to an owner, adjustments are made to the owner's basis in the passthrough interest. The adjusted basis of the passthrough interest is reduced (but not below zero) by the amount of any money distributed to the owner, and also by the amount of the basis to the owner of distributed property other than money.¹⁵²

¹⁵² In addition, under new section 713(1)(A), the owner's adjusted basis in its passthrough interest is increased by the owner's distributive share of gain recognized by the passthrough under new section 731(b) on the distribution.

Example 1.—Assume that A and B are owners of passthrough AB and that A and B have 50-percent distributive shares of all items. A and B each have a \$1,000 adjusted basis in their passthrough interests.

Assume that passthrough AB distributes \$600 cash to owner B and distributes to owner A property with an adjusted basis to the passthrough of \$500 and a fair market value of \$600. The passthrough recognizes \$100 of gain on the deemed sale of the property in connection with the property distribution to A. A and B each have \$50 of gain. The basis of the distributed property to A is its adjusted basis to the passthrough immediately before the distribution, or \$500, plus the gain recognized by the passthrough on the distribution, or \$100, for a total adjusted basis in distributee owner A's hands of \$600 for the distributed property. A's basis in its passthrough interest is increased to \$1,050 by A's \$50 distributive share of the passthrough's gain under new section 713, and reduced to \$450 by the \$600 basis of the property distributed to A. Similarly, owner B's basis is increased to \$1,050 by B's \$50 distributive share of the passthrough's gain on the distribution, and reduced to \$450 by the \$600 cash distribution to B.

Example 2.—Assume C is a passthrough owner with a basis in its passthrough interest of \$125. The passthrough distributes property to C with an adjusted basis to the passthrough of \$300 and a fair market value of \$100. The passthrough does not recognize the loss. C has a distribution of \$100 (the fair market value of the property), which does not exceed its basis, so C recognizes no gain. The property has a basis to C of \$125 (that is, the lesser of the passthrough's basis immediately before distribution of \$300 (unadjusted for gain since the passthrough recognized none), or C's basis in its passthrough interest of \$125). C reduces its basis in its passthrough interest to 0 by the amount of the basis to C of the distributed property under new section 733(2).

Example 3.—Assume D is a passthrough owner with a basis in its passthrough interest of \$100. The passthrough distributes property to D with an adjusted basis to the passthrough of \$300 and a fair market value of \$150. The passthrough does not recognize the loss. D has a distribution of \$150 (the fair market value of the property) which exceeds D's 100 basis in its passthrough interest; D has \$50 of gain.¹⁵³

The distributed property has a basis to D of \$150. That is, the basis of the property in D's hands is the lesser of (a) the passthrough's basis immediately before distribution of \$300 (unadjusted for gain since the passthrough recognized none), or (b) D's basis in its passthrough interest immediately before the distribution of \$100; once the lesser of these is determined to be \$100, the \$100 is increased by the \$50 of new section 731(a)(2) gain D recognized, totaling \$150. Meanwhile, the basis of D's passthrough interest is increased after the distribution by the \$50 of new section 731(a)(2) gain to \$150.¹⁵⁴ D reduces its basis in its passthrough interest to 0 by the \$150 basis to D of the distributed property.¹⁵⁵

¹⁵³ New sec. 731(a)(2).

¹⁵⁴ New sec. 713(1)(A).

¹⁵⁵ New secs. 733(2) and 713(2)(A).

15. Adjustments to basis of undistributed property (sec. 231 of the discussion draft and new sec. 734 of the Code)

To prevent shifts of basis from a distributee owner to or from the other owners, the discussion draft provides that, in the case of any distribution to an owner, the passthrough adjusts the basis of remaining passthrough property. Under this rule, each remaining owner's net liquidation amount immediately after the distribution is required to equal that owner's net liquidation amount immediately before the distribution, taking into account gain recognized by the passthrough on the distribution under new section 731(b).

In the case of a distribution of property to an owner other than in liquidation of the owner's passthrough interest,¹⁵⁶ the adjustments take into account (1) the amount of any gain recognized by that owner with respect to the distribution under new section 731(a), and (2) the net amount of loss (if any) that would be recognized by that owner if the owner sold the distributed property at fair market value immediately after the distribution. For this purpose, loss (if any) on the distributed property is intended to be determined after taking account of adjustments to the basis of the property resulting from the distribution under new section 732.

The net liquidation amount means, with respect to any owner, the net amount of gain or loss that would be taken into account by the owner under new section 711 if the passthrough sold all of its assets at fair market value (and no other amounts were taken into account under new section 711). Thus, for example, other items of income, gain, or loss of the passthrough during the taxable year are not taken into account for this purpose.

Basis is allocated among the remaining passthrough properties. Negative adjustments are made first to property other than unrealized receivables and inventory items to the extent thereof. Positive adjustments are made only to property other than unrealized receivables and inventory property. In the case of a basis decrease, if there is insufficient adjusted basis in passthrough property, each owner recognizes gain in the amount of the prevented decrease. In the case of a basis increase, if there is no passthrough property whose basis may be increased, a loss is allowed to each owner in the amount of the prevented increase. The gain or loss is treated as from the sale of the passthrough interest.¹⁵⁷

No allocation of basis may be made to stock in a C corporation (or any person related to it) that is an owner of the the passthrough. Any amount not allocable to the stock is allocated to other passthrough property, or is recognized as gain by the passthrough to the extent the amount required to be allocated to other passthrough property exceeds the aggregate adjusted basis of the other property immediately before any basis allocations are made under this provision with

¹⁵⁶ Under new section 761(f) as provided by the discussion draft, a liquidation of an owner's passthrough interest means the termination of an owner's entire passthrough interest by means of a distribution, or a series of distributions, to the owner by the passthrough.

¹⁵⁷ New sec. 741. Thus, generally the gain or loss is treated as capital gain or loss except as otherwise provided in new sections 723 or 751(b).

respect to the distribution. For this purpose, relatedness is determined under present law section 267(b) or new section 762(b)(1).

If a distribution of passthrough property requires a basis adjustment to an upper-tier passthrough's interest in a lower-tier passthrough, then the lower-tier passthrough is required to make a corresponding adjustment to the adjusted basis of its passthrough property.¹⁵⁸ These corresponding adjustments are required through successive tiers of passthroughs, and only with respect to the passthrough's proportionate share of the adjusted basis of lower-tier passthrough property. An upper-tier passthrough is required to furnish the lower-tier passthrough (in such manner as the Secretary prescribes) the information necessary to enable the lower-tier passthrough to make the basis adjustments.

Example.--Assume that passthrough A-K has 10 equal owners. The passthrough has two assets, X with an adjusted basis of \$50 and a fair market value of \$10, and Y with an adjusted basis of \$4,500 and a fair market value of \$3,140. Thus, X has a built-in loss of \$40 and Y has a built-in loss of \$1,360. Passthrough A-K would have a loss of \$1,400 if it sold all its assets for their fair market values.

The passthrough distributes property X to owner A in a nonliquidating distribution that does not reduce A's interest in the passthrough.¹⁵⁹ Immediately before the distribution, A has an adjusted basis in his passthrough interest of \$500. The passthrough recognizes no gain on the distribution, nor does A. A's basis in distributed property X is \$50 (the same as the passthrough's adjusted basis in property X immediately before the distribution),¹⁶⁰ and A's basis in his passthrough interest is reduced by \$50 to \$450.¹⁶¹

The net liquidation amount of each of passthrough A-K's 10 owners immediately before the distribution is a loss of \$140. That is, if the passthrough sold all of its assets immediately before the distribution at a loss of \$1,400, and no other amounts were taken into account, then each of the 10 equal owners would have a \$140 share of this loss.

After the distribution to A, but before any inside basis adjustments, the net liquidation amount of each owner other than A is \$136, or \$4 less than before the distribution. This is each of those owners' share if the passthrough were to sell its remaining asset, Y, for \$3,140 at a loss of \$1,360. Owner A also has a \$136 share of this loss. Further, owner A would also have \$40 loss if A sold property X that was distributed to him, for a total potential loss of \$176, or \$36 more than before the distribution. An adjustment is required by new section 734(b)(2) to take account of A's \$36 additional potential loss which has been shifted to him in the distribution.

¹⁵⁸ New section 735 as provided by the discussion draft.

¹⁵⁹ For simplicity, assume that the other partners have received cash distributions equal to the fair market value of A's property distribution, so that there is no reduction in A's interest in the passthrough.

¹⁶⁰ New sec. 732.

¹⁶¹ New sec. 733.

Under the provision, the basis of remaining passthrough property Y is reduced from \$4,500 to \$4,140 with respect to A. A's distributive share of the loss on the sale of property Y at its fair market value of \$3,140 would then be reduced by \$36 to \$100. Taking into account this \$100 and the \$40 outside loss on property X, A's net liquidation amount after the distribution is \$140, the same amount as before the distribution.

Further, the basis of property Y is increased from \$4,500 to \$4,536 with respect to the other nine partners. Thus, each of the other nine partners' share of loss on the sale of property Y for its fair market value of \$3,140 would be increased by \$4 to \$140, the same as their net liquidation amounts before the distribution.

16. Corresponding adjustment to basis of properties held by lower-tier passthrough in case of upper-tier passthrough basis adjustments (sec. 231 of the discussion draft and new sec. 735 of the Code)

The discussion draft supplies rules applicable to tiered passthroughs in the event adjustments are required to the basis of passthrough property.

If a distribution of passthrough property requires a basis adjustment to an upper-tier passthrough's interest in a lower tier passthrough, then the lower-tier passthrough is required to make a corresponding adjustment to the adjusted basis of its passthrough property. Similarly, if a distribution of an interest in a lower-tier passthrough to an upper-tier passthrough (or a sale or exchange of an interest in an upper-tier passthrough that holds an interest in a lower-tier passthrough) results in an increase or a decrease in the basis of the passthrough interest in the hands of the distributee owner, then a corresponding basis increase or decrease is required in the property of the lower-tier passthrough. These corresponding adjustments are required through successive tiers of passthroughs, and only with respect to the passthrough's proportionate share of the adjusted basis of lower-tier passthrough property.

An upper-tier passthrough is required to furnish the lower-tier passthrough (in such manner as the Secretary prescribes) the information necessary to enable the lower-tier passthrough to make the basis adjustments.

17. Recognition and character of gain or loss on sale or exchange (sec. 231 of the discussion draft and new sec. 741 of the Code)

The sale or exchange by an owner of a passthrough interest is generally treated as the sale or exchange of a capital asset, except as otherwise provided in new section 723 (relating to the character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property) or new section 751 (relating to unrealized receivables and inventory items). However, no loss is recognized on the sale, exchange, or other disposition of a passthrough interest unless the disposition constitutes the disposition of all direct and indirect interests of the owner in the passthrough. Any loss not recognized as a result is suspended and is recognized on the termination of all the owner's direct and indirect interests in the passthrough.

18. Basis of transferee owner's passthrough interest (sec. 231 of the discussion draft and new sec. 742 of the Code)

The basis of a passthrough interest acquired other than by contribution to the passthrough is determined under the basis rules of general application in part II of subchapter O of the Code. For example, the basis of a purchased passthrough interest is generally its cost.¹⁶²

19. Adjustment to basis of passthrough property (sec. 231 of the discussion draft and new sec. 743 of the Code)

The provision requires basis adjustments to passthrough property in the case of a transfer of the interest by sale or exchange or upon the death of an owner. These adjustments are with respect only to the transferee owner. Adjustments are made to the basis of passthrough property with respect to the transferee owner to account for the difference between the transferee owner's proportionate share of the adjusted basis of the passthrough property and the transferee's basis in its passthrough interest. These adjustments are intended to adjust the basis of passthrough property to approximate the result of a direct purchase of the property by the transferee owner.

For this purpose, an owner's proportionate share of the adjusted basis of passthrough property is determined in accordance with his economic interest in the passthrough. The rules of new section 712(d) (relating to contributed property) apply in determining the proportionate share. Depletion of passthrough property is determined separately with respect to a transferee owner.

Basis allocations among properties generally are allocated to reduce the difference between the fair market values and adjusted basis of passthrough properties and by making allocations to property of a like kind among properties which are (1) capital assets and property used in a trade or business and (2) other properties. The basis of passthrough property may not be reduced below zero.

If a sale or exchange of an interest in an upper-tier passthrough that holds an interest in a lower-tier passthrough results in an increase or a decrease in the basis of the passthrough interest in the hands of the distributee owner, then a corresponding basis increase or decrease is required in the property of the lower-tier passthrough.¹⁶³ These corresponding adjustments are required through successive tiers of passthroughs, and only with respect to the passthrough's proportionate share of the adjusted basis of lower-tier passthrough property. An upper-tier passthrough is required to furnish the lower-tier passthrough (in such manner as the Secretary prescribes) the information necessary to enable the lower-tier passthrough to make the basis adjustments.

¹⁶² Sec. 1012.

¹⁶³ New sec. 735.

20. Unrealized receivables and inventory items (sec. 231 of the discussion draft and new sec. 751 of the Code)

Gain or loss from the sale or exchange of a passthrough interest generally is treated as gain or loss from the sale or exchange of a capital asset.¹⁶⁴ However, under the provision, gain is treated as ordinary income on the sale or exchange of a passthrough interest of a passthrough holding unrealized receivables or inventory items to the extent thereof.

Certain distributions are treated as sales or exchanges if a passthrough holds unrealized receivables or inventory. To the extent an owner receives in a distribution any passthrough property that is unrealized receivables or inventory items in exchange for all or a part of his interest in other passthrough property (including money), or vice versa, the transaction is treated under regulations as a sale or exchange of the property between the distributee owner and the passthrough (as constituted after the distribution). This treatment is provided to prevent reallocation among the owners of ordinary income and capital gain. This treatment does not apply to the distribution of property the distributee contributed to the passthrough.

Inventory items mean stock in trade, inventory, and property held for sale to customers within the meaning of present law section 1221(1), other property that is not a capital asset nor section 1231 property, and any other property that, if held by the selling or distributee owner, would be considered property of these types.

Unrealized receivables generally includes amounts for the right to payment for goods sold (otherwise treated as ordinary income) and services, to the extent not previously included in income. In addition, for purposes of new sections 731 (relating to gain or loss on distributions), 732 (relating to basis of distributed property other than money), 734 (relating to adjustment to basis of undistributed passthrough property), and 741 (relating to recognition and character of gain or loss on sale or exchange of passthrough interest), unrealized receivables includes any property other than an inventory item but only to the extent of the amount that would be treated as ordinary income if the property were sold by the passthrough for its fair market value.

In the case of tiered passthroughs, a passthrough is treated as owning its proportionate share of unrealized receivables or inventory items of any other passthrough in which it is an owner. Its proportionate share is determined in accordance with its economic interest in the passthrough as determined under new section 743. Similar rules apply in the case of interests in trusts.

21. Treatment of certain liabilities (sec. 231 of the discussion draft and new sec. 752 of the Code)

Under the discussion draft, any increase in an owner's share of the liabilities of a passthrough, or any increase in an owner's individual liabilities through assumption of passthrough liabilities, is considered as a contribution of money by the owner to the passthrough. Any decrease in an owner's share of the liabilities of a passthrough, or any decrease in an

¹⁶⁴ New sec. 741.

owner's individual liabilities through assumption by the passthrough of those individual liabilities, is considered as a distribution of money to the owner by the passthrough.

For purposes of the provision, a liability to which property is subject is considered as a liability of the owner of the property, to the extent of the fair market value of the property. In the case of a sale or exchange of a passthrough interest, liabilities are treated in the same manner as they are treated in connection with the sale or exchange of property not associated with passthroughs.

22. Definitions (sec. 231 of the discussion draft and new sec. 761 of the Code)

The provision defines a number of terms for purposes of new subchapter K.

An "owner" is a shareholder, partner, member, or person acting in a similar capacity with respect to a passthrough.

A "passthrough interest" is an interest in the equity or profits of a passthrough.

A "passthrough item" consists of each item, contribution, and tax described in new section 711(a) with respect to which an owner may receive a distributive share.

An owner's "distributive share" (when expressed as a percentage) cannot be less than zero and, must, when added to the distributive share of all other owners, total 100 percent of the allocated item.

An "ownership agreement" includes any modifications of the agreement made prior to, or at, the time prescribed by law for filing the passthrough return for the taxable year (not including extensions) which are agreed to by all the owners, or that are adopted in such other manner as may be provided by the agreement.

The "liquidation of an owner's passthrough interest" means the termination of an owner's entire passthrough interest by means of a distribution, or a series of distributions, to the owner by the passthrough.

With respect to any taxable year, a "C corporation" is any corporation that is not a passthrough for such taxable year.

23. Transactions between owner and passthrough (sec. 231 of the discussion draft and new sec. 762 of the Code)

Owners not acting in capacity as owners

In general, when services are provided to a passthrough by a nonowner, the passthrough may deduct amounts paid or incurred for such services (unless such expenses are required to be capitalized), and the party providing the services must include an equivalent amount in income. This rule also applies to services provided by an owner acting in a capacity other than as an owner of the passthrough.

Similar to present law section 707(a), the provision provides that where an owner engages in a transaction with a passthrough other than in his capacity as an owner of the passthrough, the transaction may be considered as occurring between the passthrough and a person that is not an owner. In general, this rule applies if an owner performs services for (or transfers property to) a passthrough, there is a related direct or indirect distribution to the owner, and the performance of the services (or transfer) and the distribution (when viewed together) are properly characterized as a transaction occurring between the passthrough and an owner acting other than in his capacity as an owner of the passthrough. Further, this rule generally applies if an owner (directly or indirectly) transfers money or other property to a passthrough, there is a related direct or indirect transfer of money or other property by the passthrough to the owner, and the transfers (when viewed together) are properly characterized as a transaction occurring between the passthrough and an owner acting other than in his capacity as an owner of the passthrough or as a transaction between two or more owners acting other than in their capacity as owners of the passthrough.

The provision also applies when an owner performs services for the passthrough and is paid reasonable compensation, including wages, by the passthrough for such services.

The provision is not intended to disturb any requirement by the passthrough to capitalize (*e.g.*, under section 263) amounts paid or incurred by the passthrough when an owner engages in a transaction with the passthrough other than in his capacity as an owner of such passthrough.

Certain sales or exchanges of property with respect to controlled passthroughs

Special rules apply with respect to any direct or indirect sale or exchange of property (other than an interest in the passthrough) between (1) a passthrough and a person owning, directly or indirectly, more than 50 percent of the interest in the passthrough, or (2) two passthroughs where the same person owns, directly or indirectly, more than 50 percent of the passthrough interests. Ownership of a passthrough interest is determined in accordance with the rules for constructive ownership of stock provided in section 267(c).

Consistent with present law section 707(b)(1), no deduction of losses is allowed from the direct or indirect sale or exchange of property as described in (1) or (2) above. In the case of a subsequent sale or exchange of such property at a gain, gain must only be recognized to the extent it exceeds the losses disallowed by this provision.¹⁶⁵

As in present law section 707(b)(2), in the case of a direct or indirect sale or exchange of property (other than a capital asset as defined in section 1221) between (1) or (2) described above, any gain recognized is characterized as ordinary income.

¹⁶⁵ The provision applies section 267(d) as if the losses were disallowed under section 267(a)(1).

24. Taxable years of owner and passthrough (sec. 231 of the discussion draft and new sec. 763 of the Code)

Year in which partnership income is includible

In computing the taxable income of an owner for a taxable year, the inclusions required by new section 711 are based on the passthrough items of the passthrough for any taxable year of the passthrough ending within or with the taxable year of the owner.

Taxable year of a passthrough

The taxable year of a passthrough is permitted by the provision to be a year ending December 31, or any other accounting period for which the passthrough establishes (to the satisfaction of the Secretary) a business purpose. Any deferral of income to owners is not considered a business purpose.

An owner is prohibited from changing to a taxable year other than that of a passthrough in which he is a principal owner unless he establishes (to the satisfaction of the Secretary) a business purpose for such change in taxable year. The provision defines principal owner as an owner having a passthrough interest of five percent or more.

Closing of a passthrough year

Similar to present law section 706(c), except in the case of a termination of a passthrough or as discussed below, the taxable year of a passthrough will not close as the result of the death of an owner, the entry of a new owner, the liquidation of an owner's passthrough interest, or the sale or exchange of an owner's interest.

The taxable year of a passthrough closes with respect to an owner whose entire passthrough interest terminates (whether by reason of death, liquidation, or otherwise). However, the taxable year of a passthrough shall not close with respect to an owner (1) who sells or exchanges less than his entire passthrough interest or (2) whose passthrough interest is reduced (whether by entry of a new owner, partial liquidation of an owner's passthrough interest, gift, or otherwise).¹⁶⁶

Determination of distributive share when owner's interest changes

The provision adopts the rules under present law section 706(d). Except as provided below, if there is a change in any owner's interest in the passthrough, each owner's distributive share of any items of income, gain, loss, deduction, or credit of the passthrough for the taxable year is determined using any method prescribed in regulations taking into account the varying interest of the owners in the passthrough during such taxable year.

¹⁶⁶ Notwithstanding this sentence, a taxable year shall close in accordance with the taxable year normal operating rules described in new section 763(b).

In certain instances, cash basis items are required to be prorated over the period to which they are attributed. To the extent the passthrough used the cash receipts and disbursements method with respect to these items, proration is required for interest, taxes, payments for services or for the use of property, and any other item specified in regulations that requires use of the proration method to avoid significant misstatements of the owner's income.

Items attributable to interest in a lower-tier passthrough are required to be prorated over the entire taxable year if (1) during any taxable year of the passthrough, there is a change in any owner's interest in the upper-tier passthrough and (2) such passthrough is an owner in a lower-tier passthrough.

25. Continuity of passthrough (sec. 231 of the discussion draft and new sec. 764 of the Code)

The provision adopts the rules under present law section 708 for partnerships with respect to continuity of a passthrough; a passthrough continues until it is terminated. Under these rules, a passthrough is deemed to terminate only if (1) the passthrough's operations cease to be carried on by any of its owners, or (2) within a 12-month period there is an aggregate sale or exchange of at least 50 percent of the passthrough interests.

In the case of a merger or consolidation of two or more passthroughs, a continuing passthrough is the passthrough whose owners possess a greater than 50 percent interest in the resulting passthrough.

In the division of a passthrough into two or more passthroughs, a resulting passthrough is considered a continuation of the prior passthrough if its owners owned over 50 percent of the prior passthrough.

26. Distributions of passthrough interests treated as exchanges (sec. 231 of the discussion draft and new sec. 765 of the Code)

Except as provided in regulations, the provision requires any distribution of a passthrough interest to be treated as an exchange for purposes of new sections 743(a) and (b), new section 764, and any other provision specified in regulations.

27. Coordination with Subchapter C (sec. 231 of the discussion draft and new sec. 771 of the Code)

Under the provision, subchapter C shall not apply to any passthrough corporation and its shareholders.

The provision otherwise contains the following rules that mirror present law rules relating to S corporations that were formerly C corporations, or that become C corporations after having been an S corporation:

- No carryforward and no carryback arising from a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is a passthrough corporation.

- No carryforward and no carryback shall arise at the corporate level for a taxable year for which a corporation is a passthrough corporation.
- Nothing in those provisions shall prevent treating a taxable year for which a corporation is a passthrough corporation as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or forward.

An election to be a passthrough corporation shall be treated as a mere change in the form of conducting a trade or business for purposes of the second sentence of section 50(a)(4). However, a passthrough corporation shall continue to be liable for any tax under section 49(b) (relating to increases in qualified nonrecourse financing) or section 50(a) (relating to recapture of investment credit on certain dispositions) attributable to credits allowed for taxable years for which such corporation was not a passthrough corporation. In the case of any increase in tax for which the corporation is liable under sections 49(b) or 50(a) that relate to credits taken while the entity was a C corporation, accumulated earnings and profits shall be adjusted for the amount of the tax.

Any distribution of money by a C corporation that was formerly a passthrough corporation, with respect to its stock during a post-termination transition period, shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.¹⁶⁷ A corporation may elect to have this rule not apply to all distributions made during a post-termination transition period, provided that all shareholders of the corporation to whom distributions are made by the corporation during the post-termination transition period consent to such election. As a result of such election, distributions are applied against accumulated earnings and profits and treated as dividends.

The post termination transition period means: (A) the period beginning on the day after the last day of the corporation's last year as a passthrough corporation and ending on the later of (i) the date which is one year after such last day or (ii) the date for filing the return for such last year as a passthrough corporation (including extensions); (B) the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts an item of income, gain, loss, deduction, or credit of the corporation arising during the passthrough period, and (C) the 120-day period beginning on the date of a determination that the corporation's election under new section 703(a) had terminated for the previous taxable year. The audit-related post termination transition period described in (B) applies to a distribution only to the extent the amount of such distribution does not exceed the aggregate increase (if any) in the accumulated adjustments account by reason of the adjustments under the determination pursuant to the audit.

¹⁶⁷ See discussion of new section 772 *infra* III.B.28, Treatment of distributions of passthrough corporations with accumulated adjustment accounts.

28. Treatment of distributions of passthrough corporations with accumulated adjustment accounts (sec. 231 of the discussion draft and new sec. 772 of the Code)

As under present law rules, a passthrough corporation that has accumulated earnings and profits attributable to its former C corporation status must keep an accumulated adjustments account. This account generally includes all income and deductions recognized after the entity becomes subject to the new passthrough regime and generally is adjusted in the same manner as the basis of a passthrough entity ownership interest would be adjusted for such items. However, for this purpose, no adjustment is made for income (and related expenses) which is exempt from tax. The phrase “but not below zero” shall be disregarded with respect to downward adjustments. Further, no adjustment shall be made for Federal income taxes attributable to any taxable year in which the corporation was a C corporation. In applying the provision to distributions made during any taxable year, the amount in the accumulated adjustments account at the close of the taxable year is determined without regard to any net negative adjustment for such taxable year (*i.e.*, any excess of the reductions in the account for the taxable year other than for distributions over the increases in such account of the taxable year). The tax consequences to owners of distributions that do not exceed the accumulated adjustments account are governed by the general rules regarding distributions by passthroughs.

A distribution that exceeds the accumulated adjustments account and that would be a distribution to which section 301 would apply (but for the non-application of subchapter C to a passthrough corporation) is treated as a dividend.

It is intended that current law would continue to apply to distributions to which section 301 would thus apply. Thus, distributions in excess of the amount in the accumulated adjustment account would be treated as a dividend to the extent of earnings and profits. In addition, such distributions would lead to a downward adjustment in earnings and profits.

Also, as under present law relating to S corporations, if a passthrough corporation has accumulated earnings and profits attributable to former C corporation status immediately before it becomes subject to the new passthrough regime, the entity and its owners may elect, for any taxable year, to treat all distributions while subject to the passthrough regime as coming first out of such earnings and profits. The election must be made with the consent of all affected owners, that is, all owners to whom a distribution is made during the taxable year.

29. Tax imposed on certain built-in gains (sec. 231 of the discussion draft and new sec. 773 of the Code)

As under present law, new section 773 imposes a corporate level built-in gain tax, at the highest corporate income tax rate, on a passthrough corporation’s net recognized built-in gain.¹⁶⁸ This rule applies to gain that arose prior to the conversion of the corporation from a C corporation to a passthrough corporation, and that is recognized by the passthrough corporation during the recognition period (*i.e.*, the 5-year period beginning with the first day of the first taxable year for which the passthrough election is in effect). If the taxable income of the

¹⁶⁸ Certain built-in income items are treated as recognized built-in gain for this purpose.

passthrough corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no tax under new section 773 is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the succeeding taxable year (subject to the taxable income limitation in the succeeding taxable year).

If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under new section 773. The treatment of all payments received under the installment sale is governed by the provisions of new section 773(d)(7) applicable to the taxable year in which the sale was made.

Also, as under present law, the built-in gain tax applies to net recognized built-in gain attributable to any asset received by a passthrough corporation from a C corporation in a transaction in which the passthrough corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation. In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the passthrough corporation in lieu of the beginning of the first taxable year for which the corporation was a passthrough corporation.

Under new section 776 (described below) if a passthrough corporation was an S corporation prior to the enactment of new Subchapter K and was subject to present law section 1374 immediately prior to becoming a passthrough corporation, then the recognition period shall begin with the relevant time under present law section 1374 and all other terms of present law section 1374 shall continue to apply to the passthrough corporation in a manner recognizing that it is a successor to the S corporation.

The built-in-gain tax imposed on the passthrough corporation under new section 773 is in addition to the tax imposed on each owner on his or her share of the gain taken into account in computing the owner's taxable income. The amount of the built-in gain tax is treated as a loss by each owner of the passthrough corporation in computing the owner's income tax.

30. Tax imposed when passive investment income of corporation having accumulated earnings and profits exceeds 60 percent of gross income (sec. 231 of the discussion draft and new sec. 774 of the Code)

As under present law, new section 774 imposes corporate-level tax at the highest corporate tax rate on a passthrough corporation's excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable

deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, and annuities. Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, or certain interest and dividend income of banks and depository institution holding companies.

31. Recapture of LIFO benefits (sec. 231 of the discussion draft and new sec. 775 of the Code)

If a passthrough corporation was a C corporation for the last taxable year before the first taxable year for which the election under 703(a) is effective, and accounted for its inventoried goods under a last-in, first-out (“LIFO”) inventory method for such last taxable year, then the passthrough corporation must recapture its LIFO benefits.

The LIFO recapture amount is the excess of the inventory amount under the first-in, first-out (“FIFO”) inventory method over the inventory amount under a LIFO inventory method, as of the last taxable year the entity was a C corporation. The LIFO recapture amount is included in the gross income of the corporation for such last taxable year (and appropriate adjustments are made to the basis of inventory to take into account the amount included in gross income). Any increase in tax by reason of this provision is payable in four equal installments. The first installment is paid with the return of tax for the last taxable year for which the corporation was a C corporation, and the three succeeding installments are paid on or before the due date of the returns for the three succeeding taxable years. No interest is imposed for the period of extension by reason of these installments.

The provision is the same as present law section 1363 relating to C corporations that become S corporations.

32. Application of passthrough corporation rules to pre-existing S corporations (section 231 of the discussion draft and new section 776 of the Code)

For purposes of applying the foregoing provisions and other provisions of chapter 1 of the Code, in the case of any passthrough corporation that was an S corporation and that is treated as having made an election under new section 703 to become a passthrough corporation pursuant to new section 703(d): (1) such election shall not be taken into account in determining the first taxable year for which the corporation was a passthrough corporation, and (2) such corporation shall be treated for purposes of the such chapter as a passthrough corporation for any taxable year for which the corporation had an election in effect under section 1362 relating to S corporations (as in effect immediately before its repeal). Thus, this provision enables current S corporations to come under the new Subchapter K rules without disruption of their passthrough status under present law.

33. Withholding on distributive share of passthrough income (sec. 231 of the discussion draft and new secs. 33A and 3411 of the Code)

Under the provision, a passthrough is required to pay with respect to each passthrough owner a withholding tax at a rate of [X] percent of the excess of the owner’s distributive share of

items of income and gain over the owner's distributive share of items of deduction and loss. The determination of the withheld amount is made separately with respect to ordinary items and capital gain rate items if the owner has a different distributive share for the category of ordinary items than for the category of capital gain rate items.

Except as otherwise provided in regulations, the tax withheld by a passthrough is treated as distributed to the owner. The distribution is considered to take place on the earlier of the day that the passthrough pays the tax, or the last day of the passthrough's taxable year for which the tax was paid. Thus, under new section 713(2), the owner's basis in its passthrough interest is decreased (but not below zero) by the amount of the distribution (*i.e.*, by the amount withheld).

Except as otherwise provided in regulations or guidance, the withholding tax is treated as a tax imposed under section 11 (relating to corporate income tax) and any passthrough required to pay the tax is treated as a corporation for purposes of the rules relating to failure by a corporation to pay estimated income tax.

Thus, any underpayment generally is treated like an underpayment of corporate estimated tax by a corporation. The determination of any applicable additions to tax, the determination of the amount and period of any underpayment, and other rules applicable to any failure to pay are the same as are applicable to failure by a corporation to pay estimated income tax under section 6655, except as otherwise provided in regulations or guidance. Assessment and collection with respect to any underpayment of the withholding tax generally takes place at the passthrough level.

The withholding tax under this provision does not apply with respect to any foreign partner to which present law section 1446 applies.

An owner of a passthrough interest is allowed a refundable income tax credit for the amount withheld.¹⁶⁹

C. Effective Date

The provisions are effective for taxable years of passthroughs beginning after December 31, 2013.

¹⁶⁹ New sec. 33A.