RATIONALIZING THE TAXATION OF BUSINESS ENTITIES

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I. INTRODUCTION

As Congress begins to consider the most significant restructuring of the Code in history, policymakers should not pass on their best opportunity to return substance to the federal tax system.[1] The history of business taxation in the United States is an illustration of policy decisions evolving into meaningless form. The classical system that derives from a 1909 congressional decision to treat corporations and partnerships differently for federal tax purposes[2] was intended as a means of regulating corporations. From its inception, the distinctions between corporations and partnerships were difficult to quantify. Congress defined the term "corporation" to include joint-stock companies, associations, and insurance companies,[3] and the Treasury Department (Treasury) developed rules to determine whether an entity was an association taxable as a corporation, a partnership, or a trust. As these rules evolved, they became increasingly lengthy and cumbersome. Meanwhile the business world created various business entities that did not fit within the established definitions—definitions that were based on nineteenth century common law notions of corporations and partnerships. This has led taxpayers and the Service into a constant struggle to determine how these evolving business forms should be taxed.

This Article demonstrates that it has become virtually impossible to distinguish corporations from partnerships, that their disparate tax treatment under the Code creates distortions on business decisions, and that the solution is to readjust the inquiry—to establish a regime for business taxation grounded in sub-

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[1] Tax Reform has once again been thrust to the top of the national political agenda. On January 17, 1996, the bipartisan National Commission on Economic Growth and Tax Reform released its recommendations for a tax system "for the 21st century." *See* NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, UNLEASHING AMERICA'S POTENTIAL (Jan. 1996). These recommendations called for a single low rate of investment, full deductibility of payroll taxes, and a super-majority requirement for Congress to raise the tax rate. *Id.* Although the commission's report sketched broad goals, the details soon will be fleshed out as the tax writing committees commence hearings. Moreover, with nearly all of the major presidential contenders campaigning on some version of tax reform, this issue will remain at the forefront of the domestic agenda for the foreseeable future.

[2] The first attempt at a modern federal income tax imposed a tax on corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. Similarly, the Corporation Excise Tax of 1909 imposed a special excise tax on every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company. Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112.

[3] War Revenue Act, ch. 63, § 200, 40 Stat. 300, 302 (1917).

stantive policy. Congress has achieved some integration through subchapter S, but that is not enough. The time has come for a new system of business taxation that is based on substance—a system in which the incidence of tax would fall on all business activity, regardless of form. Using three models for tax reform, the business activity tax (BAT),[4] the Hall-Rabushka flat tax,[5] and the national sales tax,[6] this Article illustrates how a tax regime based on substantive policy goals[7] not only would achieve the current goal of simplification, but also would accomplish a more important goal of removing tax considerations from business decisions. This shift from form toward substance would be a welcome reform to the Code.

II. HISTORICAL BACKGROUND

The classical system of taxation that imposes a tax on corporations and individuals, but no tax on partnerships, has been an integral part of the American income tax since its inception. Part II first will examine the origins of the classical system, searching for the rationale behind the entity tax on corporations. Part II then will examine how the tax law defines partnerships and corporations, and how Congress has attempted to narrow the differences.

A. *Origins of the Disparate Corporate and Partnership Regimes*

Throughout the history of the federal income tax, Congress has chosen to treat corporations and partnerships differently for tax purposes. The first evidence of this decision is found in the history of the Revenue Act of 1894.[8] It imposed a tax on the net income of all corporations, companies, and associations doing business for profit, no matter how created or organized.[9] But this broad applica-

[4] The BAT first was introduced as a bill in Congress in 1994. *See* S. 2160, 103d Cong., 2d Sess. (1994).

[5] ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (1995), *reprinted in* 68 TAX NOTES SPECIAL REPORT 3 (Aug. 4, 1995).

[6] No proposals to replace the income tax with a national sales tax have been introduced in Congress to date, but Indiana Republican Senator Richard Lugar, a 1996 presidential candidate, has proposed this reform as part of his campaign. Senator Lugar's plan would eliminate the Service and require the individual states to collect the national sales tax with their state sales taxes, and to then turn the proceeds from the national tax over to the Treasury. *See* JOINT COMM. ON TAX'N, 104TH CONG., 1ST SESS., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX (Comm. Print 1995) [hereinafter JOINT COMMITTEE REPORT].

[7] All three models for tax reform are based on principles of consumption taxation. The two substantive goals of a consumption tax are (1) to lower the cost of capital for investment or to increase the rate of return on savings, and (2) to provide simplicity to the tax system. *See* Joel B. Slemrod, *The Simplification Potential of Alternatives to the Income Tax*, 66 TAX NOTES 1331, 1334 (Feb. 27, 1995).

[8] Revenue Act of 1894, ch. 349, § 32, 28 Stat 509, 556. The tax imposed by the Act was held unconstitutional because it was not apportioned among the states according to population, as required by Article I, Section 9, Clause 4, of the Constitution. Pollack v. Farmer's Loan & Trust Co., 157 U.S. 429, 581 (1894), *aff'd on reh'g*, 158 U.S. 601, 637 (1895).

[9] Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556.

tion specifically excluded partnerships.[10] The Senate debate on this provision demonstrates that Congress did not intend to tax partnerships.[11]

Responding to *Pollack v. Farmer's Loan & Trust Co.*[12] and the overwhelming need for revenue, Congress imposed an excise tax on the privilege of doing business as a corporation in 1909.[13] This tax was intended also to improve federal supervision over the business transactions of corporations.[14] As stated by President Taft:

> [T]he faculty of assuming a corporate form has been of the utmost utility in the business world, [but] it is also true that substantially all of the abuses and all of the evils which have aroused the public to the necessity of reform were made possible by the use of this very faculty.[15]

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[10] *Id.* The regulations issued pursuant to the Act stated that "[p]artnerships, as such, are not liable to taxation of firm or partnership profits or income, but each individual member of the partnership shall include his share . . . where he is required by law to make return of his income for taxation." REGULATIONS AND LAW RELATIVE TO INCOME TAX 17, 25 (Dec. 13, 1894), *microformed on* Executive Branch Documents 1789-1909, No. T2217-21 (U.S. Gov't Printing Office).

[11] Following is the relevant Senate discussion:

> Mr. Allison. I should be glad to have the Senator from Missouri state, whether he understands that [these sections] are intended to deal with anything but associated corporations?
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> Mr. Vest. That is the meaning of it. I have not had any doubt about it. If I had intended to use the word "partnerships," I should have said "partnerships." For instance, take building and loan associations. That is the way they style themselves. They are not called "companies;" they are not called "corporations" *eo nomine*, but they are called "associations." Two or more individuals associate themselves, and we have a chapter in the Revised Statutes of Missouri which provides for these associations. They are quasi corporations.
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> Mr. Hale. That is not a private business partnership. . . .
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> Mr. Hoar. I should like to inquire of the committee, in order to make clear what I understand they say is their meaning, whether there is any objection to adding after the word "organized" the words "but not including partnerships?" I am afraid that the phrase "companies or associations" . . . "no matter how created and organized," does include partnerships.
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> Mr. Vest. This language is taken from the act of 1864. That act uses the words "corporations or associations."
>
> Mr. Hoar. Not "companies?"
>
> Mr. Vest. Yes, "companies, corporations, or associations . . . . "
>
> Mr. Hoar. It does not say "company." It is not the purpose of this section to include partnerships. They are dealt with in another way . . . .

26 CONG. REC. 6690, 6833-35 (1894). Most of the preceding legislative history was reprinted in the first comprehensive study on classification. *See* Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

[12] 157 U.S. 429, 581.

[13] Tariff of 1909, ch. 6, 36 Stat. 11.

[14] PRESIDENT'S MESSAGE TO THE CONGRESS, S. Doc. No. 98, 61st Cong., 1st Sess. 3 (1909). The history of the Corporation Excise Tax of 1909, and how it resulted from the Progressive Era's thirst for corporate regulation is well documented in Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 INDIANA L.J. 53 (1990).

[15] PRESIDENT'S MESSAGE TO THE CONGRESS, S. Doc. No. 98, 61st Cong., 1st Sess. 3 (1909).

Congress realized that this system would create horizontal inequities—that some small businesses form as corporations, and others as partnerships, but that the former would be disadvantaged.[16] Nonetheless, it was because of the distinct feature of limited liability that Congress intended the special tax on corporations as a regulatory measure by which the government could gain knowledge of their business transactions.[17]

The ratification of the Sixteenth Amendment empowered Congress to impose a direct income tax of the type struck down in *Pollack*.[18] The permanent income tax established in 1913 was levied on gains and profits of corporations, joint-stock companies, and associations, however created or organized, but not on those of partnerships.[19]

The term "corporation" was first defined in 1917, as part of the Excess Profits Tax Act,[20] and retained the following year, providing that "[t]he term 'corporation' includes associations, joint-stock companies, and insurance companies."[21] In the 1918 House debate, the definition was clarified to embrace more than the traditional corporation, *i.e.*, to include unincorporated associations. The term "association," although not defined in the act, was defined in the debate as meaning a number of people, whether organized under law or voluntarily.[22] The debate also indicated that Congress was not imposing a tax on partnerships directly, because Congress intended to make the individual the unit of taxation,[23] whereas, presumably, a corporation was viewed as an individual entity, separate from its owners.

Congress was not unaware that it had established disparate tax regimes for corporations and partnerships. In a 1919 report to Congress, Treasury Secretary Carter Glass noted the following:

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[16] 44 CONG. REC. 4157 (1909) (documenting the debate between Senators Bacon and Hale).

[17] It was not until 1933 when Congress enacted the first of several major acts intended to regulate the transaction of business by corporations. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933).

[18] "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

[19] Revenue Act of 1913, ch. 16, § II(A)(2), 38 Stat. 114, 166-67. A draft of this legislation would have imposed the tax on "all companies, whether incorporated or partnership," but the language including partnerships was removed in the Senate. *See* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861 983 (1938).

[20] Revenue Act of 1917, ch. 63, § 200, 40 Stat. 300, 302. The 1917 Act defined corporations as including "joint-stock companies or associations and insurance companies." *Id.*

[21] Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057, 1058.

[22] Congressman Garner referred the House to the dictionary to define the term "association," signifying that it had no particular definition, but was intended very broadly. 56 CONG. REC. 10,418 (1918).

[23] *Id.* at 10,420 (1918) (documenting the remarks of Representative Hull).

> The treatment of partnerships and corporations under the present legislation is radically different. The ordinary corporation of a given size or class in a particular line of business may pay fifty percent of its net income in income and profits taxes, whereas the members of the average partnership in the same line of business may pay only twenty percent of their net income in normal and additional income taxes. . . . This vital difference turns upon the mere form of organization, yet the two forms of business may be in close competition. It is suggested that different treatment in the tax law should turn upon distinctions of fact and not form, and that real distinction exists between the closely owned corporation whose stockholders give their principal time and attention to the business of the corporation, and those very large corporations whose stockholders are widely scattered and are in many respects investors rather than owners.[24]

Despite this acknowledgement that the tax impact on business depended on form, not substance, and did not provide horizontal equity, Congress abstained from providing a remedy and allowed Treasury to deal with the problem via regulations.

B. *The Regulatory Evolution: From Substance to Form*

Ever since Congress chose to tax corporations and partnerships differently, the Service and Treasury have struggled to write regulations drawing the line between the two tax regimes. When regulations were first written, they distinguished associations taxable as corporations from partnerships by examining the rights created under state law. As state law differences have narrowed, it has become increasingly difficult for the government to toe the line.

1. *Early Regulations*

The first regulatory attempt to distinguish between associations and partnerships was made in 1919, when Treasury issued Regulations 45. These rules focused on the transferability of interests and the existence of centralization of management to determine the classification of unincorporated entities.[25] In addition, Treasury emphasized limited liability, requiring certain limited partnerships and partnership associations to be classified as associations. Noting that the state label is not dispositive, but rather that essential characteristics provided under state law are determinative, Regulations 45 characterized certain limited partnerships as associations.[26]

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[24] CARTER GLASS, NOTES ON THE REVENUE ACT OF 1918, *reprinted in* EDWARD D. REAMS, JR., 94 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950, 6 (1979).

[25] Regs. 45, art. 1503 (1919).

[26] Limited partnerships that limited liability for all members, provided for free transferability of interests, and that were capable of holding real estate and bringing suit in the common name, were found to be "more truly corporations than partnerships." Regs. 45, art. 1506 (1919).

In 1932, Congress defined partnerships broadly, including many business forms not known as partnerships under common law.[27] The 1935 regulatory interpretation of this definition focused on two characteristics that required classification as an association taxable as a corporation: whether the organization had (1) continuity of life and (2) centralized management.[28]

2. Morrissey v. Commissioner

The Supreme Court's most significant pronouncements on classification came in 1935,[29] when four opinions were issued.[30] In *Morrissey v. Commissioner*,[31] the Court held that the inclusion of associations with corporations in the statute "implies resemblance; but it is resemblance and not identity,"[32] and set forth seven characteristics common to corporations: (1) associates entering into a joint enterprise for the transaction of business, (2) the ability of an entity to hold title to property in the corporate name, (3) centralized management, (4) continuity of life, (5) free transferability of interests, (6) limitation of personal liability of the participants, and (7) an objective to carry on business and divide the gains therefrom.[33] The Court then explained that several of these characteristics could be used to distinguish trusts from corporations, while others could be used to distinguish partnerships from corporations. Thus, the Supreme Court provided a resemblance test based on the substantive characteristics of these three business forms, as they existed in 1935.

The three cases decided with *Morrissey* expounded on the resemblance test espoused therein. In *Swanson v. Commissioner*,[34] the Court held that a trust engaged in the business of buying and selling real property so resembled a corporation that it should be classified as a corporation, notwithstanding the fact that only two beneficiaries existed and no corporate formalities were followed.[35] Similarly, in *Helvering v. Combs*,[36] the Court rejected arguments that corporate formalities were not followed, noting that the business trust at issue provided

[27] Congress defined the term "partnership" to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or estate or a corporation." Revenue Act of 1932, ch. 209, § 1111(a)(3), 47 Stat. 169, 289.

[28] Regs. 86, art. 801-4 (1935).

[29] Previously, the Court held that certain business trusts were properly classified as associations taxable as corporations. Hecht v. Malley, 265 U.S. 144 (1923). Justice Sanford surveyed numerous dictionary definitions and concluded that the term "association" includes quasi-corporate organizations engaged in business. *Id.* at 157.

[30] *See* Morrissey v. Commissioner, 296 U.S. 344 (1935); Swanson v. Commissioner, 296 U.S. 362 (1935); Helvering v. Combs, 296 U.S. 365 (1935); Helvering v. Coleman-Gilbert Associates, 296 U.S. 369 (1935).

[31] 296 U.S. 344 (1935).

[32] *Id.* at 357.

[33] *Id.* at 356, 359-60.

[34] 296 U.S. 362 (1935).

[35] *Id.* at 365.

[36] 296 U.S. 365 (1935).

associates joining in common enterprise with centralized management, continuity of life, limited liability, and free transferability of interests.[37] Finally, in *Helvering v. Coleman-Gilbert Associates*,[38] the Court held that the corporate characteristic of an objective to carry on business for profit was present because the trust agreement authorized improvement and sale of properties for profit.[39]

3. *The* Kintner *Regulations*

Notwithstanding the guidance provided by *Morrissey*,[40] Treasury did not modify its classification regulations until 1960, prompted by court decisions holding that certain associations of doctors were properly classified as associations, not partnerships.

In *United States v. Kintner*,[41] a group of Montana physicians, who had been organized as a partnership for several years, formed an association to handle their practice, wanting to qualify for certain pension plans not available to partnerships. Because Montana prohibited the practice of medicine by corporations, the doctors formed an association endowed with "all of the attributes of a corporation." Despite these obvious tax motives, the Ninth Circuit refused to disregard the classification regulations as the Service had argued,[42] holding that *Morrissey* and the regulations required the association to be classified as a corporation.[43]

All of this led to the 1960 revisions—the *Kintner* regulations—which remain largely intact today.[44] Although focused on the *Morrissey* criteria, the regulations were biased towards partnership classification. The *Kintner* regulations listed six characteristics commonly found in a "pure corporation" that could be used to distinguish it from other forms of entities: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests.[45] The regulations provided that the first two characteristics could be used to distinguish trusts from corporations, while the latter four characteristics could be used to distinguish partner-

[37] *Id.* at 368-69.

[38] 296 U.S. 369 (1935).

[39] *Id.* at 373.

[40] In addition to spelling out criteria that should be used to determine the classification of entities, *Morrissey* noted that Treasury could clarify or enlarge the classification regulations "so as to meet administrative exigencies or conform to judicial decision." *Morrissey*, 296 U.S. at 355.

[41] 216 F.2d 418 (9th Cir. 1954).

[42] *Id.* at 423.

[43] Under a similar set of facts, a federal district court held that an association of doctors that was in all respects identical to a corporation, except for the fact that Texas state law prohibited the incorporation of medical practices, was properly taxable as a corporation. Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).

[44] T.D. 6503, 1960-2 C.B. 409.

[45] Regs. § 301.7701-2(a)(1) (1960).

ships from corporations.[46] Although the regulations stated that other characteristics could be used to distinguish these organizations, no such factors have been successfully applied.[47]

Citing the *Morrissey* resemblance test, the *Kintner* regulations made clear that each case required separate analysis. Nonetheless, the regulations drew bright lines, precluding classification as an association unless the organization had more corporate characteristics than non-corporate characteristics.[48] Thus, an unincorporated organization would be classified as a partnership if it had associates and a business objective, but lacked at least two of the following four corporate characteristics.

a. *Continuity of Life.* This feature exists if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member would not cause a dissolution of the organization.[49] This rule was based on the common law principle that a corporation has a continuing identity that does not depend on its shareholders, while partnerships traditionally were viewed as agency relationships between specific individuals. Thus, any provision of the organizational agreement that allowed dissolution to be triggered by the circumstances of any member that destroyed the mutual agency relationship would preclude a finding that the organization had continuity of life.[50]

b. *Centralized Management.* This is present when a person or group of persons has continuing exclusive authority to make management decisions necessary for the organization,[51] a rule that was based on the corporate model of a board of directors responsible for managing a corporation. The *Kintner* regulations specified that this centralized authority must be exclusive, *i.e.*, members who are not designated as managers cannot have concurrent authority to make management decisions. Accordingly, the mutual agency relationship between general partners would preclude any general partnership from having centralized management.[52]

c. *Limited Liability.* If, as a matter of law, no member would be personally liable for the debts of or claims against the organization, there is limited liabil-

[46] Regs. § 301.7701-2(a)(2) (1960).

[47] *See infra* notes 69-72 and accompanying text (discussing Larson v. Commissioner, 66 T.C. 159 (1976), *acq.* 1979-2 C.B. 1., and Revenue Ruling 70-101, 1970-1 C.B. 278).

[48] Regs. § 301.7701-2(a)(3) (1960).

[49] Regs. § 301.7701-2(b)(1) (1960).

[50] *See* Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8. In *Glensder Textile*, the court concluded that a limited partnership lacked continuity of life because upon the death, retirement, or incapacity of a general partner, the remaining general partners would have to agree to continue the partnership, and there was no assurance that they would so agree. The court distinguished this contingent continuity from the chartered life of a corporation, which continues irrespective of the status of its directors or shareholders. *Id.* at 184.

[51] Regs. § 301.7701-2(c)(1) (1960).

[52] *See* Regs. § 301.7701-2(c)(4) (1960).

ity,[53] a rule that has existed since the times of canon law.[54] In 1960, no domestic partnership statute provided for the creation of a partnership in which no member would be subject to personal liability. The Uniform Limited Partnership Act provided limited liability only to limited partners; general partners remained subject to personal liability.[55]

d. *Free Transferability.* The final corporate characteristic described in the *Kintner* regulations relates to the ability of the owners to transfer their interests in the organization. Because a partnership was traditionally viewed as an agency relationship between specific individuals, while a corporation was viewed as a separate juridical person, a change in ownership of a partnership represented a more significant event. Following the traditional notion that a share of corporate stock can be sold freely without approval, the regulations describe an organization as having a corporate characteristic if the members can substitute a nonmember for themselves, without the consent of the other members.[56]

As a general proposition, and consistent with its tilt towards partnership treatment, the *Kintner* regulations specifically stated that general partnerships subject to statutes corresponding to the Uniform Partnership Act could not have the corporate characteristics of continuity of life, centralized management, or limited liability.[57] This *per se* partnership definition led taxpayers and the Service to their next significant confrontations in this area.

4. *Application of the* Kintner *Regulations*

In response to the *Kintner* regulations, several states enacted statutes providing for the formation of professional service corporations. These organizations were intended to establish the same arrangements described in *Kintner* and *Galt*.[58] Because the *Kintner* regulations had been designed to classify *Kintner* associations as partnerships by requiring partnership classification for organizations with two corporate and two noncorporate characteristics, various states created entities for use by professionals that would be classified as corporations under the new regulations. This led to an amendment of the regulations in 1965,[59] requiring these professional service organizations to be classified under the *Kintner* regulations.[60]

[53] Regs. § 301.7701-2(d)(1) (1960).

[54] *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 15 (3d ed. 1983).

[55] UNIF. LIMITED PARTNERSHIP ACT § 7, 6 U.L.A. 582 (1969).

[56] Regs. § 301.7701-2(e)(1) (1960).

[57] *See* Regs. § 301.7701-2(b)(3), (c)(4), (d)(1) (1960).

[58] *See supra* notes 41-43 and accompanying text.

[59] T.D. 6797, 1965-1 C.B. 553.

[60] Because the Code set forth a specific method of taxation for corporations, entities organized under state corporation statutes had never been subject to classification. *See* Boris I. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 26 (1961).

But these amendments did not withstand judicial scrutiny. The first challenge came in *United States v. Empey*,[61] which held that the 1965 amendments were invalid and that a corporation was entitled to be treated as a corporation for federal tax purposes.[62] Noting the rationale behind the 1965 amendments, the Tenth Circuit held that the effect of the changes would be to alter the legislative definition of the term "corporation."[63] Because the Service had consistently treated an entity chartered and operated in good faith as a corporation under state law as a corporation for federal tax purposes,[64] and because the *Kintner* regulations were directed only to unincorporated organizations,[65] the court held that the 1965 amendments could have no effect on a duly chartered Colorado professional service corporation. Two other circuits reached the same result.[66]

Following these consistent rejections of the 1965 amendments, the Service announced in Revenue Ruling 70-101,[67] that it would treat professional service organizations similar to those examined in *Empey*, *O'Neill*, and *Kurzner*, as corporations for tax purposes. The Service cautioned, however, that a professional service organization must be both organized and operated as a corporation to be classified as a corporation.[68]

After losing this battle, the Service next targeted the tax shelter limited partnership. In *Larson v. Commissioner*,[69] the Tax Court agreed that the limited partnership resembled a corporation, but held that because the regulations require each corporate characteristic to be weighed equally—thereby requiring a mechanical approach to "a subject otherwise fraught with imponderables"—proper application of the *Kintner* regulations required classification as a partnership.[70] In addition, the court rejected other factors (the Service had urged consideration of the corporate feature of providing for pooled investments with limited liability for participants) as being subsumed with the four corporate characteristics. Judge Tannenwald, in his majority opinion, concluded that if the corporate

[61] 406 F.2d 157 (10th Cir. 1969).

[62] *Id.* at 169.

[63] "It is fairly obvious that the purpose of the amendment of January 28, 1965, was to prevent a professional service organization from being able to qualify as a corporation for tax purposes under the [Code]." *Id.* at 164.

[64] *Id.* at 165.

[65] *Id.* at 168.

[66] In O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969), the court held that the inquiry should be limited to whether the state granted existence to a corporate entity under state law. The Fifth Circuit delved deeper, re-examining the *Morrissey* resemblance test, and then applying the corporate characteristics of the *Kintner* Regulations to find that a Florida professional service corporation should be classified as a corporation for federal tax purposes. Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969).

[67] 1970-1 C.B. 278.

[68] *See* T.D. 7515, 1977-2 C.B. 482 (withdrawing the 1965 amendments).

[69] 66 T.C. 159 (1976), *acq.* 1979-2 C.B. 1. The original opinion in *Larson* was filed on October 21, 1975. That opinion was withdrawn, however, on November 7, 1975. The final opinion was issued on April 27, 1976.

[70] *Id.* at 172.

resemblance test set forth in *Morrissey* prevailed, the limited partnerships should have been classified as corporations.[71] Significant in the court's opinion, as well as in several concurring and dissenting opinions, was the message that the *Kintner* regulations should be revised.[72]

5. *The Twenty-Four Hour Regulations*

Responding to the calls in *Larson* to reconsider the *Kintner* regulations, Treasury proposed new classification regulations on January 5, 1977.[73] The proposed regulations would have retained the six corporate characteristics enumerated in the *Kintner* regulations, but would have required a *Morrissey* resemblance analysis.[74] In addition, the proposed regulations would have classified an unincorporated organization as an association if it resembled a corporation with respect to two or more of the four characteristics used to distinguish partnerships from corporations.[75] As a result of an immediate outcry from numerous sources, including the Department of Housing and Urban Development (HUD),[76] the proposed rules were withdrawn just twenty-four hours after publication.[77] The Service announced its acquiescence to *Larson* two years later.[78]

6. *Limited Liability as a Super Factor*

In addition to being the year with the shortest-lived tax regulations in history, 1977 was the year in which Wyoming created the limited liability company (LLC),[79] an unincorporated entity created to secure the federal tax advantages of a partnerships and state-law limited liability for all participants.[80] This innovation raised a new problem for the Service—whether an organization that offered

[71] In a contemporaneous decision, the Court of Claims held that a limited partnership was properly classified as a partnership under the regulations. Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975). In dicta, that court interpreted the *Kintner* regulations to include a general rule that any partnership lacking two or more of the four corporate characteristics is classified as a partnership. *Id.* at 743.

[72] *See, e.g.*, 66 T.C. at 185; 66 T.C. at 188 (Dawson, C.J., concurring); 66 T.C. at 192 (Raum, J., dissenting); 66 T.C. at 192 (Drennan, J., dissenting); 66 T.C. at 202 (Quealy, J., dissenting).

[73] Prop. Regs. § 301.7702-1 to -2, 42 Fed. Reg. 1038 (1977).

[74] Prop. Regs. § 301.7701-2(a), 42 Fed. Reg. 1038 (1977).

[75] *Id.*

[76] HUD was concerned that the proposed rules would limit the ability of investors to use limited partnerships, classified as partnerships, to develop low-income housing projects. *See* Note, *Tax Classification of Limited Partnerships: The IRS Bombards The Tax Shelters*, 52 N.Y.U. L. REV. 408, 410-11 (1977).

[77] 42 Fed. Reg. 1489 (1977).

[78] 1979-1 C.B. 1.

[79] WYO. STAT. § 17-15-101 to 136 (1977).

[80] *See generally* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1994); Armando Gomez, *Limited Liability Companies: Passthrough Entity of the Future*, 12 J. STATE TAX'N, Vol. 3, at 1 (1994); Jill E. Darrow, *Limited Liability Companies and S Corporations: Deciding Which is Optimal*, 48 TAX LAW. 1 (1994); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992).

limited liability to all participants could be classified as a partnership—and it would take eleven years for the resolution of that problem.[81]

Concluding that an entity providing limited liability to all participants should not escape corporate tax treatment, the Carter administration proposed amendments to the *Kintner* regulations that would prevent this problem.[82] The proposed rules would have established limited liability as a "super factor," requiring association classification for any organization with associates and a business objective if no member was personally liable for the debts of the organization under local law.

The public commentary on the super factor regulations was overwhelmingly unfavorable.[83] Two lobbies were particularly outspoken. The equipment leasing industry was in the practice of using certain business trusts solely for the limited liability afforded the entities, but it desired partnership taxation.[84] In addition, international investors argued that because many foreign nations did not provide for investment in entities lacking limited liability (many Latin American countries used the *limitada* as the primary vehicle for investment), U.S. investors would be disadvantaged.[85]

This public commentary led the Service to withdraw the super factor regulations pending a new study of the classification regulations.[86]

7. *Congressional Restrictions on Tax Shelters*

While the Service and Treasury were losing the classification battles both in the courts and in the regulatory arena, Congress continued to look at limited partnerships as tax shelters and produced two significant legislative changes. In 1986, Congress enacted section 469, limiting the ability of individuals, partnerships, and certain corporations, to use losses from passive activities.[87] In 1987, Congress attempted to return classification to the *Morrissey* resemblance test by requiring certain publicly traded partnerships to be treated as corporations for tax purposes.[88] These legislative changes stripped partnerships of some utility as

[81] The Wyoming LLC act was enacted in 1977; Rev. Rul. 88-76, 1988-2 C.B. 360, which addresses the classification of a Wyoming LLC, was not issued until late 1988.

[82] Prop. Regs. § 301.7701-2, 45 Fed. Reg. 75,709 (1980).

[83] *See* 48 Fed. Reg. 14,389 (1983).

[84] *See Equipment Lessors Seek Modification of Proposed Regulations on Limited Liability Companies*, 17 TAX NOTES 801, 815 (Dec. 13, 1982).

[85] *See Proposed Regulations on Limited Liability Companies Are Criticized*, 15 TAX NOTES 161, 187-88 (Apr. 19, 1982).

[86] I.R.S. News Rel. 145, 82-10 CCH ¶ 6851, 1983 P-H ¶ 54,703 (Dec. 16, 1982).

[87] Tax Reform Act of 1986, Pub. L. No. 99-514, § 501, 100 Stat. 2085, 2233-41 (1986). *See generally* CONGRESSIONAL RESEARCH SERVICE, REPORT FOR CONGRESS, THE PASSIVE ACTIVITY LOSS RULES (1991) (reviewing the legislation and the subsequent regulations).

[88] I.R.C. § 7704. The publicly traded partnership rule was first proposed by the Carter Administration in 1978. In his tax message, President Carter requested Congress to classify "nominal partnerships as corporations for tax purposes." H.R. DOC. No. 283, 95th Cong., 2d Sess. 11 (1978). The rule proposed in 1978 would have classified new limited partnerships with more than fifteen limited partners as corporations, unless the partnership was engaged in housing activities.

tax shelters, but did not resolve the continuing debate on classification of unincorporated organizations.

8. *The Limited Liability Company Rulings*

Following these congressional limitations on the use of tax shelters, Treasury concluded its study of the classification regulations, leaving the *Kintner* regulations intact. With this decision, and the acquiescence in *Larson*, the Service had no choice but to allow partnership classification of LLCs.[89] In Revenue Ruling 88-76,[90] the Service ruled that a Wyoming LLC lacked continuity of life and free transferability of interests, and therefore was classified as a partnership.

The Wyoming ruling opened the floodgates to LLC legislation among the states. Currently forty-eight states and the District of Columbia have enacted legislation providing for LLCs.[91] Moreover, the Service has issued seventeen additional revenue rulings analyzing the LLC statutes of various states.[92]

Because the LLC is a more flexible entity than the limited partnership, practitioners and the Service had difficulty applying the *Kintner* regulations to this new entity. After several years of study, the Service announced its position on the application of the regulations to LLCs in Revenue Procedure 95-10.[93] That promulgation is particularly interesting because it demonstrates how the *Kintner* regulations have been liberalized in the thirty-five years since their enactment. As a result, it is now easier to achieve partnership status for an entity that is practically indistinguishable from a corporation. This is easily demonstrated by a look at the liberalization of each of the relevant corporate characteristics.

a. *Continuity of Life.* The current rules measure continuity by the member-managers, by permitting a vote to continue by only a majority in interest of the remaining members, and by allowing as few as one dissolution event. The regulations thus allow an entity to resemble closely the chartered life of a corpora-

[89] The only real barrier to partnership classification of LLCs was the proposed super factor regulations that were withdrawn in 1982. *See supra* note 79 and accompanying text. In light of the withdrawal of those regulations, as well as statements by Treasury that the super factor rule had been abandoned, the LLC as partnership determination was inevitable.

[90] 1988-2 C.B. 360.

[91] LLC legislation also has been introduced in Hawaii and Vermont, the two states yet to provide for this business form. *See* Bruce P. Ely, *The LLC Scoreboard*, 9 STATE TAX NOTES 1560 (Nov. 27, 1995); Tom Moccia, *Governor Signs Single-Sales-Factor and LLC/LLP Bills*, 9 STATE TAX NOTES 1589 (Dec. 4, 1995).

[92] Rev. Rul. 95-9, 1995-3 I.R.B. 17 (Jan. 17) (South Dakota); Rev. Rul. 94-79, 1994-2 C.B. 409 (Connecticut); Rev. Rul. 94-51, 1994-2 C.B. 407 (New Jersey); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kansas); Rev. Rul. 94-6, 1994-1 C.B. 314 (Alabama); Rev. Rul. 94-5, 1994-1 C.B. 312 (Louisiana); Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona); Rev. Rul. 93-92, 1993-2 C.B. 318 (Oklahoma); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah); Rev. Rul. 93-81, 1993-2 C.B. 314 (Rhode Island); Rev. Rul. 93-53, 1993-2 C.B. 312 (Florida); Rev. Rul. 93-50, 1993-2 C.B. 310 (West Virginia); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois); Rev. Rul. 93-38, 1993-1 C.B. 233 (Delaware); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nevada); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colorado); Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia).

[93] 1995-1 C.B. 501.

tion discussed in *Glensder Textile*.[94] For example, if an LLC is formed with two member-managers, both of whom have sufficient resources as to pose little risk of bankruptcy, and dissolution is tied to the bankruptcy of the member-managers, it is not likely that a dissolution event ever will occur. If one of the member-managers did enter bankruptcy, only a majority in interest of the remaining members would have to vote to continue, thereby minimizing the potential for minority interests to hold the LLC hostage.

b. *Centralized Management.* The usual rule that centralized management exists if any person, or group of persons, has continuing exclusive authority to make management decisions for the organization does not apply if the designated member-managers own in the aggregate at least twenty percent of the total interest in the entity.[95] Thus, if an LLC is formed with three members and designates as manager the one which owns forty percent of the interests, the LLC may lack centralized management.

c. *Limited Liability.* In several states it is possible for a member of an LLC to assume personal liability for debts of the LLC.[96] Accordingly, if a member validly assumes personal liability for all LLC obligations and that member maintains a net worth equal to at least ten percent of the total contributions to the LLC, then the LLC does not have limited liability. This alternative is more often used in the context of foreign entities because it would be the rare case that any member of a domestic LLC agreed to assume personal liability for the debts of the entity.[97]

d. *Free Transferability.* Revenue Procedure 95-10 provides that this feature does not exist if members owning more than twenty percent of all interests cannot transfer their interests without the consent of a majority of the nontransferring member-managers. This restriction on transferability is not significant. For example, an investment LLC could be formed with one twenty percent member, three member-managers, and fifty investing members. The LLC would not have free transferability of interests if the twenty percent member's interest is restricted, but the fifty investing members have no restrictions on transferring their shares. This scenario demonstrates how an LLC effectively can have minimal restrictions on transferability.

The liberalized classification regulations now allow disparate tax treatment for entities that are distinguishable in form only, but not substance. For instance, a close corporation and an LLC, each formed to operate a real estate business,

[94] *See supra* note 50 and accompanying text.

[95] This rule does not apply if the member-managers are subject to periodic election. Rev. Proc. 95-10, 1995-1 C.B. 501.

[96] *See, e.g.*, VA. CODE ANN. § 13.1-1019 (Michie 1995).

[97] For example, it is often difficult to obtain partnership classification for some foreign entities because their operating statutes do not provide for the contingent continuity of life that is most often used by domestic LLCs to obtain partnership classification. Because these entities need free transferability of centralized management, they will attempt to lack limited liability so that they can qualify as a partnership for U.S. tax purposes.

can appear similar in terms of rights afforded by state law, but the corporation will be taxed as a corporation while the LLC will be taxed as a partnership. Depending on the terms of the close corporation's shareholders agreement, the LLC more truly may resemble a traditional corporation than the close corporation, but its tax treatment will be preferable.

9. *Notice 95-14*

Recognizing that the evolution of the *Kintner* regulations and the development of new business entities have narrowed dramatically the distinctions between partnerships and corporations to the point of virtual indistinguishability, the Service and Treasury are studying the elimination of the classification rules. Notice 95-14[98] suggests replacing the *Kintner* regulations with an elective system, whereby owners of certain entities could choose their tax classification. A decision to implement this system would confirm that the application of the classification regulations has become so formalistic that the substance has been lost.[99]

The elective system described in Notice 95-14 would be available only to unincorporated business organizations. Those organizations whose classification is dictated by the Code, such as corporations,[100] publicly traded partnerships,[101] taxable mortgage pools,[102] and real estate mortgage investment conduits,[103] would not be eligible for such an election. Thus, the effect of the elective system would be to remove the regulatory distinction between traditional general partnerships and newer entities, such as the LLC and the limited liability partnership. As stated in Notice 95-14, regulations permitting an elective system would not change dramatically the current law.[104] Rather, the elective regime would eliminate the formalities with which taxpayers must presently comply.

As states have created new forms of business entities during the past eighty years, the distinctions between corporations and partnerships have evaporated. Recognizing that there is no longer an identifiable point along the continuum at which a line may be drawn, Notice 95-14 confirms that classification has completed its shift from substance to form.[105]

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[98] 1995-1 C.B. 297.

[99] In Notice 95-14, the Service and Treasury announced that they are considering simplifying the classification regulations to allow taxpayers to treat unincorporated business organizations as partnerships or as associations on an elective basis. Comments were requested on this and other possible approaches to simplifying the regulations.

[100] I.R.C. § 7701(a)(3).

[101] I.R.C. § 7704.

[102] I.R.C. § 7701(i).

[103] I.R.C. § 860D(b).

[104] Notice 95-14 does suggest, however, that in the context of foreign organizations, there may be a substantial change.

[105] Regulations implementing the proposals outlined in Notice 95-14 were expected to be proposed during the first quarter of 1996. *See Treasury Official Urges Partnerships, Even Potential Ones, To Use New Rules*, Daily Tax Report (Jan. 22, 1996).

C. *Defining Corporation*

While *Morrissey* and the *Kintner* regulations sought to distinguish partnerships from associations taxable as corporations, a related line of cases and other developments have attempted to define what constitutes a corporation. Although the Code defines corporation expansively, including entities not labeled as such, it does not specify what constitutes a corporation.

In the seminal case defining corporateness, *Dartmouth College v. Woodward*,[106] Chief Justice Marshall wrote,

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. . . . Among the most important are immortality, and, if the expression may be allowed, individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. . . . [Moreover,] the government has given it the power to take and to hold property in a particular form, and for particular purposes.[107]

This definition—a legal entity established by charter with perpetual succession—was based on the long-established theory that corporations are fictional persons[108] and set corporations apart from other business entities until the development of limited partnerships and LLCs. Traditionally, only a corporation was recognized as an entity separate from its owners, and only a corporation could hold title to property in its name. As business needs have changed, limited partnerships, LLCs, and related entities now enjoy these privileges under state law.

Most of the tax decisions in this area have been decided with reference to the classification regulations. In *Galt v. United States*,[109] however, a federal district court determined that an association of doctors established under Texas law that met all of the requirements for incorporation, except the prohibition against doctors incorporating, should be treated as a corporation for tax purposes. Although the court referred to *Dartmouth College*, the decision was based on the practical notion that two entities different in name only should not receive disparate tax treatment.[110]

Although *Galt* disregarded the label fixed by state law, a number of other courts held that entities formed pursuant to state corporation codes are corporations *per se*, and cannot be classified otherwise for tax purposes.[111] When the

[106] 17 U.S. 518 (1819).

[107] *Id.* at 636-37.

[108] *See* ISAAC M. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS 4-5 (1927).

[109] 175 F. Supp. 360 (N.D. Tex. 1959).

[110] *Id.* at 362.

[111] *See supra* note 43 and accompanying text.

Service and Treasury attempted to classify certain professional service corporations as partnerships, the courts uniformly invalidated the regulations requiring this treatment. One court rejected any analogy to *Morrissey*, holding that the Supreme Court had not defined the term "corporation" but had instead distinguished a trust from a corporation or a partnership,[112] thus rendering the *Dartmouth College* definition no longer relevant in the context of domestic corporations: corporate classification was required for entities labeled corporations under state law.

In the foreign context, when attempting to classify a Nigerian organization, the Service compared the nature of incorporation under Nigerian law to that of U.S. law. Noting that Nigerian law derives from English law, the Service concluded that the concept of the artificial being must be present in Nigerian law, and that the *Dartmouth College* test controlled to determine that the Nigerian entity was incorporated under local law and that the classification regulations were inapplicable.[113]

The *Dartmouth College* test later was simplified, when the Service focused on whether an entity has status as a separate juridical person under local law.[114] By removing the focus from the traditions of common law, the juridical person test was applicable to entities formed under either common law or civil law.

Although the new emphasis on the juridical person test allowed the Service to classify foreign organizations without regard to the classification regulations, Revenue Ruling 73-254[115] seemed to reverse this position. In that ruling, the Service announced that the classification regulations govern the status of a foreign unincorporated business organization which has a U.S. citizen as a member.

The conflict between the juridical person test and Revenue Ruling 73-254 did not survive. In General Counsel Memorandum 36910,[116] the Service reconsidered the juridical person test and concluded that it was not administrable. In the interests of simplification and providing equitable treatment to all taxpayers, the Service decided to apply the classification regulations to all unincorporated entities.[117] In Revenue Ruling 88-8,[118] the Service announced that all entities formed under foreign law would be classified under the regulations.

Beginning with *Dartmouth College* and the common law traditions of incorporation, it has been difficult to reach a conclusive definition of the term "corporation." After the professional service corporation cases and Revenue Ruling 88-8, the only answer remaining is that an entity formed pursuant to a domestic

[112] O'Neill v. United States, 410 F.2d 888, 890 (6th Cir. 1969).
[113] G.C.M. 34376 (Nov. 13, 1970).
[114] G.C.M. 35294 (Apr. 6, 1973).
[115] 1973-1 C.B. 613.
[116] (Nov. 4, 1976).
[117] *See* G.C.M. 37953 (May 14, 1979) (concluding that an entity formed under the close corporation provisions of the Texas Business Corporation Act was a corporation *per se*, but deciding against publication of a ruling in order to avoid the appearance that the state label would control classification).
[118] 1988-1 C.B. 403.

corporation act will be treated as a corporation *per se*, but that all other entities will be subject to classification under the regulations.[119] Thus, since 1819 when *Dartmouth College* was decided, the tax law has moved no closer to a definitive statement on the meaning of incorporation.

D. *Proposals to Integrate the Corporate Tax System*

Perhaps in response to the inability to develop concrete definitions of corporations and partnerships, Congress and Treasury have considered corporate integration a solution to classification and the horizontal inequities created by the classical system.[120] Generally, corporate integration would eliminate the "double tax" by taxing corporate income at either the shareholder or corporate level, but not both. True integration would eliminate the problems inherent in the entity distinctions required under the Code today. This section discusses several proposals to achieve some level of integration.[121]

1. *Elective Integration: Subchapter S*

In 1946, Treasury issued a report titled "The Postwar Corporation Tax Structure" that laid the foundation for what would become subchapter S.[122] This report stated that the classical system discourages incorporation in many cases, thereby resulting in a loss of the social advantages of an efficient form of organization,[123] and suggested that a partnership approach would be appropriate for most small corporations, because they are "little more than chartered partnerships or proprietorships with limited liability."[124] Although the 1946 report did not make specific recommendations, the substance of its comments received prompt congressional consideration.

When the various revenue acts were codified in 1954, Congress considered

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[119] However, in Private Letter Ruling 9551032 (Sept. 27, 1995), the Service held that a Texas limited banking association would be classified as a corporation *per se*. The new Texas statute under which the bank was formed resembled the Texas LLC statute and was not part of the Texas corporation act. The ruling relied on local law, as well as the fact that the federal scheme for taxing banks is premised on the notion that banks are incorporated, to reject the taxpayer's request to be classified as a partnership.

[120] *See, e.g.*, Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case For Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565 (1995); Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437 (1995); Matthew P. Haskins, *The Theory and Politics of Tax Integration*, TAX NOTES TODAY (Apr. 24, 1995) (LEXIS, FEDTAX, TNT file, elec. cit. 95 TNT 79-86).

[121] *See Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992) (surveying proposals for corporate integration, economic analysis of its likely effects, and the need for subchapter S in an integrated system).

[122] DEPARTMENT OF THE TREASURY, THE POSTWAR CORPORATION TAX STRUCTURE (1946), *reprinted in* EDWARD D. REAMS, JR., 122 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 (1979).

[123] *Id.* at 13.

[124] *Id.* at 32-33.

elective integration.[125] The Senate bill called for elections for certain corporations, partnerships, and proprietorships as to their taxable status.[126] These elections would have enabled qualified corporations to elect to be treated as partnerships subject to subchapter K.[127] This election would have to have been filed within sixty days of the close of the first taxable year. In addition, the bill would have required unanimous consent of the shareholders for the election, and the election would have been irrevocable. The bill would have limited the election to corporations with no more than ten shareholders, all of whom would have to have been individual citizens or resident aliens (or partnerships with only such individuals as partners) and all of whom would have to be active in the business. Any substantial change in ownership would have required a new election. A similar election was enacted to allow unincorporated business entities to be taxed as corporations.[128] The stated purpose for the 1954 Senate proposals was to eliminate tax effects on the form of organization chosen by certain small businesses.[129] The proposals would have permitted small corporations that more nearly resembled partnerships to enjoy the advantages of the corporate form without being subjected to any tax disadvantages of incorporating. Similarly, the reverse election allowed small businesses to choose unincorporated forms, if more suitable for business operations, without being influenced by taxes.[130]

Congress established this elective integration, but in a more limited manner than originally proposed. Subchapter S, as adopted in 1958, established a new regime for taxing corporations that incorporated some, but not all, of subchapter K,[131] but with the same basic purpose of eliminating the effect of tax consequences on the choice of business form by small businesses.[132] Despite attempting to simplify choices for small businesses, Congress only muddied the waters with the 1958 S corporation act. The S corporation election was available only to qualified corporations with no more than ten shareholders and they were faced with complicated rules that attempted to mimic subchapter K. The result was a regime so complex that it warranted one commentator to write, "[T]he 1958 Act not only did not meet the original goal of eliminating tax considerations in the choice of business forms, it exacerbated the problem."[133]

[125] President Eisenhower suggested that "corporations with a small number of active stockholders be given the option to be taxed as partnerships." PRESIDENT'S BUDGET MESSAGE (1954), *reprinted in* 1954 U.S.C.C.A.N. 1557, 1567.

[126] H.R. 8300, 83d Cong., 2d Sess. §1351 (Senate bill) (1954).

[127] *Id.*

[128] *Id.* This election was repealed in 1966. *See* Act of April 14, 1966, Pub. L. No. 89-389, § 4(b)(1), 80 Stat. 116.

[129] S. REP. No. 1622, 83d Cong., 2d Sess. 118 (1954).

[130] *Id.* at 119.

[131] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650-57 (1958).

[132] S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958).

[133] DEBORAH H. SCHENK, FEDERAL TAXATION OF S CORPORATIONS § 2.04 (1994).

Realizing this failure, Congress substantially revised subchapter S in 1982.[134] These changes worked, and along with the repeal of the *General Utilities* doctrine in 1986, the use of S corporations has steadily increased during the past decade.[135]

2. *Blueprints for Tax Reform*

Treasury released a comprehensive study at the conclusion of the Ford Administration that suggested two methods to achieve corporate integration and substantive tax reform.[136] The purpose behind the suggested reform was to create "a tax system which looks like someone designed it on purpose."[137] Both proposed models for reform would have widened the tax base significantly. The comprehensive income tax model would have eliminated many of the exclusions and deductions that distort true income.[138] Because part of this distortion is caused by the corporate income tax, the proposal would have integrated the corporate and individual taxes by allocating corporate income, regardless of whether it is distributed, to individual shareholders. The second proposed model would have replaced the income tax with a cash flow based consumption tax which would subtract net savings and gifts from gross receipts to yield the tax base.[139]

Despite the attractive features of these proposals—elimination of the corporate income tax would have eliminated both the economic distortions created by the classical system and the effects of taxes on choice of business form—neither proposal has seen serious consideration in Congress.

Neutrality toward the form of business organization was a major theme of a Treasury report prepared in 1984 for the Reagan Administration.[140] Treasury I included two measures to provide horizontal equity between corporations and partnerships: first, by reclassifying certain large partnerships as corporations,[141] and second, by reducing double taxation with a fifty percent dividends paid deduction.

A 1986 Joint Committee report outlined grounds for treating an entity as a separate taxable unit: first, the extent that the entity is viewed as acting separately from its owners, rather than as their agent or alter ego, and therefore whether the entity provides limited liability to its owners, and second, whether

[134] Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

[135] The most recent data available indicates that the number of S corporation returns has increased every year since 1986. In 1992, the increase was 5.1%. I.R.S., 14-4 STATISTICS OF INCOME BULLETIN 73 (1995).

[136] DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977).

[137] *Id.* at 1.

[138] *Id.* at 3.

[139] *Id.* at 9.

[140] DEPARTMENT OF THE TREASURY, 1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 117 (1984) [hereinafter Treasury I].

[141] In 1987, this proposal was enacted as section 7704.

entity taxation (1) provides administrative advantages in tax collection, (2) could be used to prevent owners from sheltering other income with losses from the entity, and (3) is necessary to establish tax neutrality between similar forms of business enterprises.[142] On the other hand, the 1986 report suggested that entity taxation was contrary to integration of the corporate and individual tax systems and that, in the case of entities not engaged in active trades or businesses, the need for separate treatment is not clear.

3. *1992 Treasury Integration Report*

Section 634 of the Tax Reform Act of 1986[143] directed Treasury to conduct a study on reforming corporate income taxation. This study was completed in 1992, when Treasury released its integration report, which concluded that integration of the individual and corporate income taxes would eliminate economic distortions created by the classical system, and outlined two integration prototypes for further study, the Dividend Exclusion and the Comprehensive Business Income Taxation (CBIT) prototypes.[144] Beyond that, the report did not recommend specific legislative action.

The Treasury report stated four policy goals in the design of an integrated tax system: (1) uniformity of taxes on investment across sectors of the economy, (2) uniformity of tax on debt and equity, (3) minimized distortion on the choice between retaining and distributing earnings, and (4) taxing capital income only once.[145] Although the dividend exclusion and CBIT prototypes achieved these goals, Treasury recommended further study to consider how each prototype could be integrated with the individual income tax. Further, Treasury suggested additional study of revenue effects from the two proposals.

4. *S Corporation to Partnership Conversions*

In July 1995, Treasury proposed a new plan for limited integration,[146] allowing certain S corporations to convert to a partnership in a nonrecognition transaction under limited circumstances by making S corporations eligible for the elective regime outlined in Notice 95-14.[147] Thus, S corporations could elect to be taxable as partnerships, thereby providing complete integration to certain small corporations.

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[142] STAFF OF THE JOINT COMMITTEE ON TAXATION, 99TH CONG., 1ST SESS., FEDERAL INCOME TAX TREATMENT OF PASS-THROUGH ENTITIES (Comm. Print 1986).

[143] Pub. L. No. 99-514, § 634, 100 Stat. 2085, 2281 (1986).

[144] DEPARTMENT OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992).

[145] *Id.* at 13.

[146] *Samuels Suggests Giving Converting S Corporations "Check-the-Box" Partnership Election*, TAX NOTES TODAY (July 25, 1995) (LEXIS, FEDTAX, TNT file, elec. cit. 95 TNT 146-26).

[147] *See supra* notes 98-105 and accompanying text.

III. PROBLEMS WITH THE INCOME TAX

As the preceding historical discussion illustrates, the current income tax has proved difficult to administer despite the significant study, with no clear solutions of simplification and integration. This Part examines problems with the present regime that indicate that the time has come for its replacement.

A. *No Rationale for the Double Tax*

The rationale for the double tax of the classical system disappeared in the New Deal era with the establishment of distinct mechanisms to regulate corporations. In 1909, responding to the growth of a new creature—the corporation—Congress imposed a tax so that the government could examine the details of corporate transactions.[148]

In 1933 and 1934, more significant regulation of corporations was established under the Securities Regulation Acts,[149] which strictly regulate the distribution and trading of corporate securities. Their disclosure provisions provide the government and the public with the details of corporate transactions sought in 1909.[150]

Having established a method of corporate regulation distinct from taxation, Congress did not reconsider its earlier decision to regulate corporations with taxes. The classical system was continued, despite the fact that its rationale was extinguished with the Securities Regulation Acts. When Congress recognized that certain publicly traded entities were escaping the double tax, the Code was amended to protect the classical system,[151] despite the absence of a substantive basis.

B. *Disparate Tax Treatment of Similarly Situated Taxpayers*

As the historical discussion in Part II demonstrates, the principle fault of the classical system is that it creates distortions on business decisions. The retention of entity distinctions in the Code subjects similarly situated taxpayers to disparate tax treatment, thereby creating economic inefficiencies. The following examples illustrate this problem.

> *Example 1.* Individual A contracts with corporation B to start a software development business. They set up a Delaware LLC for this venture; the AB LLC will be taxed as a partnership. Individual C and corporation D begin a similar business (CD corporation) but use a Delaware business corporation instead.

Assuming that the regulations under section 7701 are amended as proposed in Notice 95-14,[152] the state law characteristics of the AB LLC are irrelevant to its

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[148] *See supra* notes 13-17 and accompanying text.

[149] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934); Securities Act of 1933, ch. 38, 48 Stat. 74 (1933).

[150] *See generally* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION (3d ed. 1995).

[151] I.R.C. § 7704.

[152] *See supra* notes 98-105 and accompanying text.

classification as a partnership. Under Delaware law, the AB LLC will appear virtually indistinguishable from the CD corporation. On these facts, the CD corporation will be disadvantaged because it will be subject to two levels of tax,[153] while the AB LLC will be entitled to flow through treatment as a partnership. Any losses generated in the first years of the venture will be trapped in the CD corporation, but will be passed through to the owners of the AB LLC. Similarly, when the ventures become profitable, profits of the CD corporation will be taxed at the corporate level and again as dividends upon distribution; profits of the AB LLC will be taxed once to the members, and will be distributed tax free. Many taxpayers plan around this problem by investing in corporate debt, rather than corporate equity. Although the interest received on corporate debt securities is ordinary income, *i.e.*, the same as dividend income, the corporation can deduct the interest payments. Thus, the classical system results in incentives to invest in debt over equity, to invest in noncorporate entities, and to retain rather than distribute corporate earnings.[154]

The horizontal inequity illustrated in the preceding example demonstrates how tax considerations cause economic inefficiencies. The mere differences in form between an incorporated entity and an unincorporated entity create this horizontal inequity. The owners of the CD corporation might understand their disadvantaged situation better if there were substantive benefits to operating as a corporation. However, because the Delaware corporation and Delaware LLC are virtually indistinguishable, there is no substance to provide comfort to C and D.

> *Example 2.* Assume that two hardware stores have operated for over thirty years each. Store X is owned by family E and store Y is owned by family F. Store X was incorporated in 1965. After the Tax Reform Act of 1986, family E elected to treat X as an S corporation. In contrast, store Y had operated as a proprietorship until 1993, when family F formed an LLC into which they contributed the business.

In this example, store Y has never been subject to more than one level of tax. However, store X was subject to two levels of tax as a C corporation, but now enjoys some passthrough benefits under subchapter S. Nonetheless, store X is still subject to two levels of tax due to accumulated earnings and profits generated prior to 1986.[155] Before family F formed its LLC, it had no liability protections under state law. Now, however, it enjoys the same protections as family E has enjoyed since the incorporation of store X in 1965. While family E paid the

[153] Because corporation CD has a corporation as a shareholder, it is ineligible to elect under subchapter S. I.R.C. § 1361(b)(1)(B).

[154] Kimberly Tan Majure, *U.S. Tax Integration and the Foreign Shareholder*, J. CORP. TAX'N 207, 209 (Autumn 1995).

[155] An S corporation with subchapter C earnings and profits will be subject to two levels of tax when certain distributions are made to its shareholders. If the amount of the distributions exceeds the accumulated adjustments account, the amount that does not exceed the earnings and profits is treated as a dividend. I.R.C. § 1368(c)(2).

double tax as a price for this liability protection in the past, it now pays the double tax because its assets are trapped in the corporate form. If it were to convert its corporation into an LLC, the conversion would be treated as a liquidation under section 336, and family E would be taxed twice on any appreciation in the value of the assets of their store. Thus, store X will remain forever disadvantaged to store Y because the LLC did not exist in 1965, when family E started its business.

One model for restructuring the classical system would address this problem of disparate tax treatment for similarly situated businesses. This model would retain a bipolar system, but would classify entities according to their size.[156] Large businesses would be taxed at the entity level, while small businesses would receive passthrough treatment. In the examples, the businesses would receive passthrough treatment until they grew to the point where they would be considered a large business. Thus, the tax regime would not distort business decisions.

C. *Difficulty of Integration*

The most significant obstacle to integration to date has been the perceived difficulties of transition. The purest model of integration is the shareholder imputation method espoused by the American Law Institute.[157] In general, this model would impose a dividend withholding tax (DWT) to be paid by corporations, the liability for which could be offset by corporate taxes paid; shareholders then would credit their allocable share of the DWT against the income they recognize on the distribution. But this type of system requires tracking shareholders, determining when income is allocated, and ascertaining how the DWT is allocated to each shareholder. Although these problems would not be insurmountable in the context of closely held businesses, imagine the difficulties of the system in the context of a publicly traded corporation whose shares are routinely traded in the millions each week.

Similarly, the favored approach of Treasury, the CBIT method, would require a lengthy transition period,[158] the complexities of which have been viewed as a significant impediment.

Therefore, the common denominator that has led policymakers to avoid complete integration is the difficulty with combining integration into the current income tax. This results from the fact that the current income tax is not organized with substantive goals, but rather is an amalgamation of legislative deci-

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[156] *See* Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105 (1991); *but see* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 818 (1992) (rejecting Berger's approach in favor of the status quo).

[157] AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (Mar. 31, 1993).

[158] *See supra* note 144 and accompanying text.

sions to tax certain groups while providing tax incentives to others. In other words, there is no overriding substance in the Code.

IV. A PROPOSAL FOR CHANGE

The preceding discussion was designed to demonstrate the problems inherent in the classical system and illustrate the difficulty of attempting to distinguish between types of entities and pointing out the consequent inequities and economic inefficiencies. The solution calls for a new regime for business taxation that is grounded in substance, *viz.*, to replace the current system of business taxation with a system that taxes all businesses in the same manner. This Part examines three proposals designed to accomplish a business taxation scheme without the inequities and inefficiencies caused by the classical system.[159]

A. *The Business Activities Tax*

The first proposal in this area was a broad based business activities tax (BAT), introduced in both the 103d and 104th Congresses.[160] It would impose a tax on the difference between gross receipts from business activity and the cost of business purchases. Thus, like a value added tax, the tax would be imposed only on the value added by each business.[161] Even though the BAT is different in that it is a subtraction-method value added tax, it yields the same results as the European credit-invoice value added tax.[162]

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[159] It is possible that other proposals for major tax reform could realize the same substantive goals. *See generally* JOINT ECONOMIC COMM., 104TH CONG., 1ST SESS., CONSEQUENCES OF REPLACING FEDERAL TAXES WITH A SALES TAX (Comm. Print 1995); JOINT COMMITTEE REPORT, supra note 6; Rachel B. Bernstein et al., *Tax Reform 1995: Looking at Two Options*, 68 TAX NOTES 327 (July 17, 1995); Michael J. Graetz, *Current Flat Tax Proposals*, 67 TAX NOTES 1256 (May 29, 1995); Slemrod, *supra* note 7. Moreover, the integration models proposed in 1992 discussed above, would achieve the substantive goals of removing distortions caused by the entity distinctions under the Code today. However, the 1992 proposals for integration do not address the congressional desire to simplify federal taxation, thereby foreclosing this option for reform from receiving serious consideration.

[160] S. 722, 104th Cong., 1st Sess. (1995); S. 2160, 103d Cong., 2d Sess. (1994). The 1995 bill is more comprehensive, and because it replaces the income tax completely, would yield more simplification, and thereby would produce more substantive reform. However, this combined BAT and consumed income tax is a work in progress—aides to Senator Domenici have said that a revised bill will be introduced in the 105th Congress. For a complete discussion of the theory behind this proposal, see Pete V. Domenici, *The UnAmerican Spirit of the Federal Income Tax*, 31 HARV. J. ON LEGIS. 273 (1994); Cliff Massa III, *The Business Activities Tax—A Primer*, 64 TAX NOTES 1219 (Aug. 29, 1994); Alvin C. Warren Jr., *The Proposal For An "Unlimited Savings Allowance,"* 68 TAX NOTES 1103 (Aug. 28, 1995).

[161] *See* Massa, *supra* note 160, at 1220.

[162] Under the subtraction method, taxpayers subtract business purchases from gross receipts to yield the taxable base. Conversely, taxpayers subject to the credit method pay the value added tax on each purchase and then receive a credit for those taxes when they remit returns to the government. *See* J. Clifton Fleming, *Scoping Out Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 392 (1995); Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 65 TAX NOTES 1547, 1549-52 (Dec. 19, 1994).

The BAT would be imposed on all business activity, regardless of its form, thereby eliminating tax considerations from choosing the form of business entity and other business decisions. Thus, the businesses described in the examples in Part III.B would be subject to the BAT; the fact that one business was incorporated or that another was a sole proprietorship would not affect the tax result.

Another significant business advantage of the BAT is that it would alter dramatically the treatment of business equipment. Because taxpayers deduct the cost of business purchases from gross receipts to determine their tax each year, businesses could expense equipment in the year of purchase, eliminating the need for depreciation and cost recovery calculations.[163] The rules for corporate reorganizations, however, would be retained to ensure that certain business reorganizations and combinations were not taxed.[164]

The goal of the BAT then is to tax the products of business equally. It serves the function of a tax, *i.e.*, to raise revenue, without affecting how businesses operate. Because it would simplify tax treatment for all taxpayers, would remove many lower income individuals and businesses from the tax rolls, and serve as a means to protect domestic markets and promote exports, the BAT is a politically acceptable form of tax reform.

1. *Exclusions for Small Businesses and Low Income Taxpayers*

Because a BAT would alter dramatically the tax treatment of many small businesses—they would now be subject to an entity level tax and have to pay more income taxes from operations because the deduction for compensation, for example, would disappear—many such businesses would obviously suffer. This result should be avoided by a carefully written exclusion. But in order to avoid the problems encountered in the partnership-corporation definitions, the exclusion must be drafted carefully and sufficiently limit the protection to the small businesses for which it is targeted.

Defining that target is a completely different ballgame. The Code uses at least three methods to define small business: (1) shareholder contribution including

[163] Although elimination of cost recovery complexities is one of the most important simplification features of the BAT, conversion from the income tax cost recovery system and its fundamental concept of adjusted basis could be problematic. For example, taxpayers currently depreciating previous purchases would be disadvantaged, as compared to taxpayers purchasing property after the effective date of the BAT. The 1995 bill would provide transition relief by allowing a phased-in deduction for unused depreciation.

[164] Section 10016 of S. 2160 would provide an exemption for nontaxable exchanges, as that term is understood under the current Code. S. 2160, 103d Cong., 2d Sess. § 10016 (1994). In addition to enumerating transactions covered by sections 332, 351, 368, and 721, the bill would grant regulatory authority under which Treasury could specify other nonrecognition transactions. As under the income tax, boot received in nonrecognition transactions would not be exempt from taxation.

paid-in surplus,[165] (2) gross receipts,[166] and (3) number of shareholders.[167] Professor Berger chose gross receipts in excess of $10 million as the standard least likely to create distortions in business planning,[168] and to avoid manipulation of that baseline, related party rules would be used to ensure that businesses under common control could not escape the entity tax by using several entities in place of one.

Other commentators have argued that section 7704 adequately separates "large" from "small."[169] Although the public-private distinction works well, it should not be the sole criterion, for that would create significant distortions.[170] For example, the section 7704 exemption of all closely held businesses, regardless of size, could enable a few individuals to buy out a publicly traded multinational corporation, using the tax savings as the financing. At the other end of the spectrum, many small firms that have listed their shares in an effort to attract capital may struggle to break even, and could be forced from the marketplace by an entity level tax.

The paid-in surplus definition also creates distortions on business decisions. Section 1244 defines a small business in terms of the aggregate amount of money and property contributed to capital and paid-in surplus not exceeding $1 million. This rule would not reach many small businesses that could structure their affairs to avoid reaching the $1 million paid-in surplus mark.

The preferred definition, then, bases the exclusion on gross receipts from business activities. All businesses would pay the BAT, regardless of entity form, number of shareholders, or capital structure. Those businesses whose activities in the marketplace are nominal would not be subject to the tax while those whose activities were markedly productive would pay the BAT.

In order to ensure that the gross receipts test functions properly, two steps would be required. First, related party attribution rules would be used to ensure that taxpayers do not smurf their businesses by forming numerous entities, each of which would have receipts below the threshold amount.[171] Second, industry specific rules could be used to ensure that certain types of business were always subject to the BAT. Under current law, section 7701(a)(3) includes insurance companies in the definition of corporation, thereby imposing a double tax on this industry. Similar rules could be used to ensure that insurance companies, banks, and other financial institutions were subject to the BAT.

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[165] I.R.C. § 1244(c)(3)(A).

[166] I.R.C. § 474(c).

[167] I.R.C. § 1361(b)(1)(A).

[168] Berger, *supra* note 156, at 164.

[169] Kurtz, *supra* note 156, at 824.

[170] Berger, *supra* note 156, at 162. Professor Berger concluded that the publicly traded standard is both underinclusive and overinclusive.

[171] The term "smurfing" has been used to connote structuring of currency transactions to avoid reporting requirements. *See* Mark F. Sommer, *Disclosure of Currency Transaction Violations: When, How, and What if You Don't?*, 47 TAX LAW. 139, 143 (1993) (stating that smurfing usually involves taking cash from drug sales and converting it into money orders of less than $10,000 each).

In addition to removing significant numbers of small businesses from the tax rolls, the BAT would provide similar relief for thousands of individuals. They would be allowed to subtract personal exemptions, a family living allowance, an unlimited savings allowance (obviously designed to encourage savings), and a limited number of itemized deductions. The limited itemized deductions would include deductions for home mortgage interest and charitable contributions. Although these deductions may distort the BAT system, they are probably necessary to ensure passage of this reform.[172] A series of progressive rates would then be applied to the resulting tax base,[173] making the BAT the only plan for substantive reform that would retain the progressivity of the Code.[174]

2. *Border Adjustments*

While the BAT would remove tax considerations from business decisions, it would provide a welcome tool with which Congress could protect domestic markets and promote exports. As introduced in the 104th Congress, the BAT is a border adjustable tax.[175] It would exclude the proceeds from export sales from taxation, but would impose a tax on proceeds from import operations. This notion of a territorial tax replicates the systems of major U.S. trading partners,[176] and is not an obstruction on free trade prohibited by the General Agreement on Tariffs and Trade (GATT).[177] Thus, the BAT would remove tax incentives for domestic businesses to relocate abroad and would level the playing field by requiring imports to be subject to the same tax as domestically produced goods.

3. *Other Exclusions*

In addition to an exclusion for small businesses, Congress would consider other exclusions for certain favored constituents. For instance, when the publicly traded partnership rule of section 7704 was enacted, Congress permanently excluded partnerships with qualifying income, and provided a ten-year grandfather rule for all partnerships existing as of the effective date of that section.[178] These exclusions should be avoided, however, as they would continue the distortions

[172] *See* Domenici, *supra* note 160, at 292-95, 297-99.

[173] The 1995 proposal would impose graduated rates of 8%, 19%, and 40% on individuals. S. 722, 104th Cong., 1st Sess., § 15 (1995).

[174] *See Tax Fairness*, WASH. POST, Apr. 27, 1995, at A20. Progressivity is presumed to be lost in a switch from an income tax to a consumption tax, but a progressive consumption tax could spur economic growth, remove the biases against long-term investment, and otherwise cure economic malaise. *Bipartisan Council Recommends Progressive Consumption Tax*, 38 HIGHLIGHTS & DOC. 3516 (Sept. 15, 1995).

[175] S. 722, 104th Cong., 1st Sess. (1995).

[176] The value added tax systems of Europe and Japan are destination oriented taxes that exempt exports. *See* Oldman & Schenk, *supra* note 162, at 1553.

[177] *See* 141 CONG. REC. 5669 (1995) (statement of Senator Nunn).

[178] I.R.C. § 7704; Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211(c), 101 Stat. 1330-405 (1987).

inherent in the current income tax. Remembering that the overriding goal of restructuring the tax system is to provide simplicity while removing the inequities and distortions that are the product of eighty years of substance deficient tax legislation, Congress should grant these favors directly, not by manipulation of the Code.

4. *Problems with Conversion*

The most difficult part of imposing a BAT would be the conversion from the income tax system. For most taxpayers, the BAT would not require new recordkeeping. By eliminating the many rules for depreciation and other preferences, the BAT would simplify tax preparation for most businesses. The two most difficult problems would be dismantling the current income tax structure and minimizing transition problems.

Because the BAT is designed to subject all business activity to the same tax, the current passthrough structures of the income tax would become irrelevant. The BAT would eliminate the benefits of investing in regulated investment companies (RICs), real estate investment trusts (REITs), and other financial products; the rules relating to them, to partnerships, to S corporations, and to other conduits would no longer be necessary. Yet, all of these businesses would not immediately be subject to the BAT. Most conduits are relatively small, and thus would qualify for the small business exemption.

Although these tax rules would no longer be necessary, most businesses likely would continue to maintain relevant records. Partnerships still will need to measure each partner's share of the enterprise for transfer and liquidation purposes, and all businesses will need to measure their gross receipts and costs of purchases to determine if they qualify for the small business exemption, and, if not, the amount of their BAT tax.

Transition rules could be the downfall of any effort at real tax reform;[179] grandfather rules and other special treatment typically included with every tax act are suspect.[180] First, such rules frequently are limited to specific taxpayers, resulting in similarly situated taxpayers receiving disparate tax treatment. Second, exemptions for large groups of taxpayers, as was the case with section 7704, minimize the effectiveness of reform. Thus, true reform cannot be achieved if transition rules of the type that Congress has long favored are implemented.[181]

[179] Although a value added tax is inherently complex, those complexities could be substantially augmented in a U.S. system if Congress attempts to direct the flow of investment capital to achieve various policy goals. *See* Fleming, *supra* note 162, at 399.

[180] *See generally* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 241 (1987).

[181] Nonetheless, it is not practical to discuss perfect tax reform. *See* Sheldon S. Cohen, *The Classic Pipe Dream: A Perfect U.S. VAT*, 64 TAX NOTES 275 (July 11, 1995).

B. *The Flat Tax*

The flat tax designed by Professors Robert E. Hall and Alvin Rabushka would replace the current income tax with an integrated system that imposes a nineteen percent rate on income of individuals and businesses.[182] Other purported flat tax proposals would merely constrict the current rate structure, leaving the Code intact with all its entity distinctions and other distortions.[183] Accordingly, this Article only considers the Hall-Rabushka flat tax as a potential vehicle for eliminating the Code's entity distinctions.

The Hall-Rabushka flat tax would impose one rate for all taxpayers on a comprehensive definition of income, thereby removing the distortions in the Code. Advocates boast that every taxpayer, individual or business, will be able to compute its federal income tax on a postcard. The proposal would classify all income as either business income or wages. The business income tax base would be calculated by subtracting specified items from total sales of goods and services,[184] and a flat rate of nineteen percent would be applied to this base. Calculation of the wage tax base is simplified—individuals would subtract their personal allowances from the sum of their wages, salary, and pension and retirement benefits.[185] The effect of these formulae is to broaden the tax bases so that the rates can be lowered.

Because the Hall-Rabushka flat tax would apply equally to all businesses, entity distinctions and their distortions would be eliminated. Regardless of their form of organization, the businesses described in the examples in Part III.B would be subject to the flat tax. Although the businesses that had qualified as partnerships or subchapter S corporations would be subject to tax as an entity,

[182] Hall and Rabushka, *supra* note 5, at 23. The flat tax has received noteriety of late, with support from the National Commission on Tax Reform, see *supra* note 1, as well as from Republican presidential contenders Senator Robert Dole, Malcom S. (Steve) Forbes Jr., and Senator Phil Gramm. Legislation based on this plan has been introduced in the 104th Congress as H.R. 2060 by Texas Republican Representative Richard K. Armey. The Armey bill would impose a 17% flat rate on both wages and business income. The bill would eliminate all current income tax deductions, including the mortgage interest deduction. To ease the transition period, the bill would impose a 20% flat rate for two years, which then would be reduced to 17%. H.R. 2060, 104th Cong., 1st Sess. (1995). The Armey plan has been introduced in the Senate as S. 1050 by Alabama Republican Senator Richard C. Shelby. S. 1050, 104th Cong., 1st Sess. (1995). S. 488, introduced by Pennsylvania Republican Senator Arlen Specter, also is based on the Hall-Rabushka flat tax, but would retain the deductions for mortgage interest and charitable contributions, and therefore would impose a 19% flat rate. S. 488, 104th Cong., 1st Sess. (1995). Similar legislation has been introduced in the House by Indiana Republican Representative Mark E. Souder. H.R. 1780, 104th Cong., 1st Sess. (1995).

[183] For example, a plan announced by Missouri Democratic Representative Richard Gephardt has been touted as a flat tax, but it is not based on the Hall-Rabushka model. The Gephardt plan would eliminate all individual deductions except that for mortgage interest, and would flatten the rate structure. *See* Barbara Kirchheimer, *Gephardt Introduces 10 Percent Tax*, 68 TAX NOTES 135 (July 10, 1995).

[184] Hall and Rabushka, *supra* note 5, at 24.

[185] Personal allowances would be calculated as follows: $16,500 for married filing jointly, $9500 for single taxpayers, and $14,000 for single heads of households. In addition, taxpayers would be allotted a $4500 personal allowance for each dependent, excluding spouses. *Id.* at 25.

they would not be disadvantaged in that dividends paid would not be included in the wage base.

Like the BAT, the Hall-Rabushka flat tax is designed to tax consumption,[186] and, as in the case of the BAT, eliminates the apparatus of deductions that so complicates the Code. Thus, purchases of plant and equipment would be subtracted from revenues in the year of purchase, thereby eliminating the need to track depreciation. Furthermore, because this tax is based on consumption, it would apply only to domestic business. Thus, the business tax base would include revenues from domestic sales and services, and would allow subtraction of only those expenses and purchases of inputs in the United States or imported into the United States.[187]

Although the Hall-Rabushka flat tax, with its promises of postcard returns, would be certain to simplify federal taxation, it is not without its difficulties. First, enactment of a tax regime that eliminates the deductions for home mortgage interest and charitable contributions may not be politically palatable and may prove unavoidable, notwithstanding that their retention produces additional distortions on economic behavior. Second, as in the case of the BAT, conversion to the Hall-Rabushka flat tax would involve numerous transition difficulties. If Congress were to favor certain interests and constituents by means of targeted tax transition rules, as discussed in Part IV.A.4, it would be stopping short of achieving true tax reform.[188] Finally, although proponents of the Hall-Rabushka flat tax believe that it would spur investment and economic growth, some economists warn that evidence of these effects is scarce and that the flat tax's lack of progressivity might lead to unfair reform.[189]

C. *The National Sales Tax*

The third widely popularized plan for major tax reform is to replace the income tax with a national sales tax.[190] It is the plan that is most likely to remove all distortions from the economy in the long term,[191] but its implementation may be politically impossible.

Although no legislation espousing a national sales tax has been introduced to date, most of its supporters describe it as the means by which the Service could be dismantled. The sales tax would replace all current revenue raising, including

[186] *Id.* at 23.

[187] *Id.* at 32.

[188] "Congress must first reform itself if any significant reform of deductions and exclusions is to come." John Copeland, *Burying the Income Tax?*, 68 TAX NOTES 1128, 1130 (Aug. 28, 1995).

[189] *See* Clay Chandler, *Flat Tax Proposals Take Center Stage*, WASH. POST, Sept. 3, 1995, at A1.

[190] This concept has been endorsed by two 1996 presidential candidates. *See* Dan Balz, *Lugar Calls for a National Sales Tax to Replace Federal Levy on Income*, WASH. POST, Apr. 6, 1995, at A9; Patrick Buchanan, *A Tax To Be Discarded*, WASH. TIMES, Apr. 15, 1994.

[191] John Godfrey, *Tax Reform Would Cause Dislocation Without Fed's Help, Kemp Panel Told*, 68 TAX NOTES 1266 (1995) (quoting Federal Reserve Board of Governors member Lawrence Lindsey).

the individual and corporate income taxes, payroll taxes, estate and gift taxes, and federal excise taxes. Thus, all businesses would be taxed identically: they would pay no income tax, but would pay sales tax on purchases and would collect sales tax on their sales. If some degree of progressivity was desired, Congress could exempt certain essential goods from the sales tax (*i.e.*, zero rating), or provide for a minimum income level in the form of refundable credits similar to the oft-criticized earned income tax credit.[192] The former option would be preferable in that it would not require calculations of income.

The two most significant impediments to a national sales tax are the rate necessary to maintain revenue neutrality and the impact of the tax on state and local governmental coffers. A recent study estimated that a rate of at least thirty-two percent would be required to maintain revenue neutrality and dismantle the Service.[193] This is unrealistically high; it cannot be afforded. One estimate predicts substantial disruptions in the markets in the immediate term,[194] and a 1994 study foresaw significant enforcement problems of a rate above ten percent.[195]

On top of all this the hard hit on states by a national sales tax must be noted.[196] Those states with no current sales tax would be required to establish new bureaucracies; those states that tie their income taxes to the federal system would have either to abandon their income tax or to complicate it with additional rules and administrators. Perhaps most importantly, states and local governments would confront strong opposition to any effort to increase their sales tax rates to finance local projects.

V. CONCLUSION

True substantive tax reform not only is possible, but would be beneficial.[197] The three models of consumption taxes discussed herein, while not the only possible vehicles for real tax reform, are designed to maintain revenues while reducing tax complexity and unfairness. The BAT is politically palatable in that its small business exemption would remove millions of taxpaying businesses from the rolls of current taxpayers. Similarly, the Hall-Rabushka flat tax would reduce most returns to postcard filings, and the national sales tax could eliminate any need to track individual income. Nonetheless, true reform will require a Congress and a President willing to sacrifice transition rules and preferences for

[192] *See* I.R.C. § 32.

[193] Bruce Bartlett, *Replacing Federal Taxes With a Sales Tax*, 68 TAX NOTES 997, 1003 (Aug. 21, 1995).

[194] *See* Godfrey, *supra* note 191, at 1266.

[195] VITO TANZI, BROOKINGS INSTITUTE, TAXATION IN AN INTEGRATED WORLD (1994).

[196] *See* Vandana Mathur, *Tax Reform, Public is Angry and Frustrated with Current Tax System, Kemp Says*, DAILY TAX REP., Aug. 21, 1995, at D6.

[197] Although the flurry of legislative proposals suggests that significant tax reform is on the horizon, it may be several years before enactment. *See* JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX (1985) (suggesting that tax reform is an incremental process, and that replacement of the income tax with a new taxing regime would take place over time, if at all).

favored constituencies in exchange for creating a system of business taxation that is both grounded in substance and free of complexity, unfairness, and economic distortion.