March 29, 2013

Skadden

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

House Ways and Means Proposal Would Change the Tax Treatment of Partnerships and S Corporations

The first congressional proposals to revamp partnership and S corporation taxation in connection with anticipated tax reform have surfaced. Framed as two alternatives, both options suggest significant, and, in the case of one alternative, fundamental, changes to the current regime.

On March 12, 2013, Rep. Dave Camp (R-Mich), the chairman of the House Committee on Ways and Means released a "discussion draft" of a bill relating to the taxation of small businesses, which predominantly addresses the taxation of partnerships and S corporations (the Discussion Draft). Chairman Camp also issued an accompanying technical explanation and invited taxpayers to provide comments on the proposed provisions. The Discussion Draft was released in connection with Ways and Means' ongoing review of options for fundamental tax reform. Chairman Camp previously released an international tax reform discussion draft in October 2011 and a financial products reform discussion draft in January 2013. In addition, Ways and Means has formed working groups, including one focused on small business and passthrough tax reform. Similarly, Chairman Max Baucus (D-Mont.) and Ranking Member Orrin Hatch (R-Utah) have announced weekly meetings on tax reform topics. Although we still do not know whether (or when) comprehensive tax reform will happen, we continue to expect that Chairman Camp and other members of Congress will push very hard to advance such legislation this year (including a mark-up of a comprehensive tax reform proposal later this year).

The Discussion Draft includes two alternative proposals for reforming the taxation of partnerships and S corporations. The first option provides for limited reform and contains some significant modifications to the current regimes applicable to partnerships and S corporations. The second option provides for fundamental reform and would replace the current regimes applicable to partnerships and S corporations with a single unified regime. The Discussion Draft does not address the taxation of other types of entities subject to special tax regimes, such as real estate investment trusts and regulated investment companies.

The following highlights several key aspects of the alternative options presented in the Discussion Draft.

Option 1

Changes would be made to the existing regimes applicable to partnerships and S corporations, including the following:

Partnerships

- The proposal would repeal the rules relating to guaranteed payments. All payments made by a partnership to a partner would be treated as either (i) a payment from the partner's distributive share of partnership income or (ii) as a payment made to a nonpartner.
- Adjustments to the basis of partnership property would become mandatory in connection with distributions of partnership property to partners

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Armando Gomez
Washington, D.C.
202.371.7868
armando.gomez@skadden.com

Brian Krause
New York
212.735.2087
brian.krause@skadden.com

Pamela Lawrence Endreny
New York
212.735.2976
pamela.endreny@skadden.com

Cary D. Pugh
Washington, D.C.
202.371.7178
cary.pugh@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

1440 New York Avenue, NW
Washington, DC 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

and transfers of partnership interests by partners, regardless of whether the partnership has made a Section 754 election.[1] In addition, lower-tier partnerships would be required to make corresponding basis adjustments at the time adjustments are made by an upper-tier partnership.

- The rules relating to "hot assets" would be modified to eliminate the requirement that inventory be "substantially appreciated" in value such to trigger gain recognition in certain partnership distributions.
- The seven-year time limitation in the so-called "anti-mixing bowl" rules of Sections 704(c) and 737 would be eliminated, which would prevent "mixing bowl" partnerships from being unwound in a tax-deferred manner. This change only would apply to property contributed to a mixing-bowl partnership after December 31, 2013.

S Corporations

- The 10-year period after the conversion of a C corporation to an S corporation during which the S corporation must pay entity level tax on certain built-in capital gains under Section 1374 would be permanently reduced to five years.
- Nonresident aliens would be permitted to be S corporation shareholders through the ownership of U.S. electing small business trusts.

Option 2

The existing regimes applicable to partnerships and S corporations would be replaced with a single unified tax regime that would apply to all "passthrough" entities. A "passthrough" entity would include partnerships and certain corporations electing to be subject to tax as "passthrough corporations." Publicly traded corporations would not be eligible to elect to be treated as "passthrough corporations." Nonetheless, the Discussion Draft does not appear to change the existing rules applicable to publicly traded partnerships under Section 7704. Although the new unified regime would most closely resemble the existing rules applicable to partnerships, it would differ from the existing rules in several significant respects, including:

- Passthrough entities would not be permitted to specially allocate items within three categories of income: (i) ordinary items, (ii) capital gain rate items and (iii) tax credits. Instead, within each of these three categories, partners generally would be restricted to a single percentage share of all of the partnership's income within such category. This change would take away one of the most attractive features of the partnership structure, which currently offers the flexibility to accommodate a wide variety of economic arrangements by allowing partners to specially allocate items of income and loss. The proposal would increase economic flexibility for S corporations, however, which currently must allocate all items on a strictly *pro rata* basis.
- Passthrough entities would be required to withhold tax on income allocable to all owners, other than foreign owners subject to Section 1446 withholding, at a yet to-be-determined rate, with the withholding credited against the owner's individual tax liability. Under this new withholding regime, all owners would be required to file for a refund with the IRS to the extent the withholding tax results in an overpayment of tax with respect to such owner. The withholding tax regime of Section 1446 would continue to apply to foreign owners.

---

1 Unless otherwise indicated, all Section references refer to the Internal Revenue Code of 1986, as amended.

- Passthrough entities would recognize gain upon the distribution of appreciated property to their owners. The gain would be allocated among the owners in accordance with their percentage shares under the revised special allocation rules. For purposes of measuring the amount of gain recognized, the passthrough entity would be treated as having sold the distributed property for its fair market value immediately prior to the distribution to its owner. This change likewise represents a significant departure from the flexible arrangements currently afforded to partnerships, where they may generally make in-kind distributions, including on a non-*pro rata* basis, without triggering current tax. Currently, the ability to distribute property on a tax-free basis is a key advantage of structuring an enterprise as a partnership rather than an S corporation. While the change may have been aimed at certain "mixing bowl" transactions, the new regime would effectively limit the ability of owners to engage in common business transactions such as restructuring or splitting up their businesses without triggering tax on built-in gain in the assets.
- Owners of passthrough entities would recognize gain to the extent that the amount of money and the fair market value of property distributed by a passthrough entity to the owner exceeded the owner's tax basis in its passthrough interest.
- Passthrough owners would not be entitled to recognize a loss upon the disposition or redemption of a partial interest in a passthrough entity. Instead, the loss would be suspended until the owner no longer owned any direct or indirect interests in the passthrough entity.
- Similar rules as proposed under Option 1 with respect to guaranteed payments, mandatory basis adjustments, and hot assets also would apply under Option 2.
- C corporations that elect passthrough entity status would be subject to a five-year built-in gain recognition period similar to current Section 1374.

Open Issues

The Discussion Draft intentionally leaves several significant technical and policy issues unaddressed, including:

- the application of employment or self-employment taxes to the owners of passthrough entities (long an area of uncertainty);
- the transition rules necessary to implement either Options 1 or 2;
- provisions addressing mergers, divisions or reorganizations of passthrough entities; and
- the treatment of foreign partners in U.S. partnerships and U.S. partners in foreign partnerships under the unified regime in Option 2.

The Ways and Means Committee also expressly invited public comment on several issues, including (i) the effect of the proposal in Option 2 to limit the use of special allocations on current partnerships that own multiple businesses (or assets) where the partners share the income from the separate businesses (or assets) in different percentages, (ii) the application of the proposed withholding tax regime in Option 2 to tax-indifferent passthrough owners, such as pension funds and tax exempt entities, and (iii) suggestions for minimizing the burden on existing S corporations and partnerships with respect to transitioning to the proposed modifications in Options 1 and 2.

The full texts of the Discussion Draft and the Technical Explanation are available at http://waysandmeans.house.gov/taxreform/default.aspx. We would be happy to discuss the Discussion Draft in more detail.