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May 17, 2002

The Honorable William M. Thomas

Chair

House Ways & Means Committee

U.S. House of Representatives

Washington, D.C. 20215

The Honorable Charles B. Rangel

Ranking Minority Member

House Ways and Means Committee

U.S. House of Representatives

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Washington, DC 20515

Gentlemen:

We write to offer our observations concerning legislation introduced last year involving S corporations.¹ On June 27, 2001, Representatives Barbara Cubin and Scott McInnis introduced legislation (H.R. 2337, the "Conversion Proposal") to permit an S corporation that has had a valid S corporation election continuously in effect for ten taxable years to transfer substantially all of its assets to a partnership or limited liability company ("LLC") taxed as a partnership on a tax-free basis, subject to satisfying requirements similar to those applicable to a corporate reorganization. In addition, on October 12, 2001, Representative Jim Ramstad proposed legislation (H.R. 3124, the "Reinvested Gain Proposal") to permit an S corporation to avoid the built-in gains tax that would otherwise apply under Section 1374 of the Internal Revenue Code of 1986 (the "Code"), if the proceeds are used within a specified period of time for certain qualified expenditures (defined broadly to include capital expenditures, deductible

¹ This letter was drafted by Janet B. Korins and Robert Smith, with helpful comments from Andrew N. Berg, Kimberly Blanchard, Samuel Dimon, Robert A. Jacobs, Gary B. Mandel, Michael Schler and Diana Wollman.

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JCT Staff Report. We generally agree with the JCT Staff Report conclusion that efforts to unify the S corporation and partnership regimes would raise competing policy concerns. While it clearly would be simpler to have one pass-through regime rather than the disparate S corporation and partnership rules, implementing the joinder of the rules would be a major project that would introduce technical complexity and raise revenue and policy concerns that may exceed the potential benefits. We have not fully evaluated this issue, but if you decide that this is a project that merits additional consideration we would be pleased to provide more detailed and substantive comments at your request. In any case we believe legislation permitting tax-free conversions of S corporations into LLCs or partnerships is ripe for consideration independent of any broader project on unifying the various pass-through regimes.

Reinvested Gain Proposal. We do not support the Reinvested Gain Proposal because it is fundamentally inconsistent with the purpose of the built-in gains tax imposed by Section 1374, which is designed to prevent the avoidance of corporate-level tax on the conversion of C corporations to S corporations. We see no reason why an S corporation should be permitted to avoid the corporate-level built-in gains tax of Code Section 1374 if sale proceeds are reinvested, while a C corporation would be fully taxed on the same transaction.

Conversion Proposal. The concept of permitting S corporations to convert to partnership status on a tax-free basis is not a new idea. The Clinton administration considered a similar proposal in 1995,³ and legislation substantially similar to the Conversion Proposal was introduced in Congress in 1999.⁴ A majority of our Committee supports legislation to permit certain

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S corporations to convert to partnerships on a tax-free basis, for the reasons and subject to the limitations discussed in more detail below. We caution, however, that certain aspects of the Conversion Proposal, as drafted, raise significant policy and technical issues that must be carefully analyzed before legislation is enacted.

The remainder of this letter highlights some of the issues that should be reviewed in more depth if similar legislation on this subject is pursued.

1. Rationale for Conversion Proposal. The basic rationale for the Conversion Proposal is to address the problem faced by individuals who elected S corporation status before the widespread use of LLCs and the availability of the check-the-box regulations.⁵ These S corporations are subject to statutory constraints, including the requirement that an S corporation have only a single class of stock and the limitations on the number and type of S corporation shareholders. While the partnership or LLC form would provide much greater flexibility, under current law the conversion from an S corporation to a partnership or LLC results in a taxable liquidation of the S corporation for federal income tax purposes.⁶ These rules differ from the partnership tax rules, which generally defer tax on a distribution of assets until the date on which the underlying assets are disposed of by the partners, or a partner disposes of its partnership interest.⁷

The issue raised by the Conversion Proposal is whether it makes sense as a policy matter to permit conversion from S corporation to partnership

⁵ Explaining the purpose of the 1999 legislation in his statement to the Senate, Senator Thomas noted that "older family businesses operated as S corporations may be 'locked' into the corporate form, simply because of the tax cost of changing to another form. These businesses are thus unable to take advantage of the recent advancements in choice of entity." See Statements on Introduced Bills and Joint Resolutions (Senate, November 10, 1999).

⁶ Under Code Section 336 an S corporation, like a C corporation, must recognize gain on the distribution of appreciated property to its shareholders. That gain would pass through to the S corporation shareholders and increase the tax basis of their stock. The basis increase would reduce the amount of gain that the shareholders would recognize in connection with the actual or deemed liquidation of the S corporation under Code Section 331. The net effect of these rules is that the liquidation of the S corporation generally would result in one layer of tax. An additional layer of tax would be imposed if the S corporation were subject to the built-in gains tax under Code Section 1374.

⁷ Code Section 731 defers gain on a liquidating distribution by a partnership unless the partner receives cash or marketable securities in excess of the partner's tax basis in the partnership or the partner receives a non-pro rata distribution from a partnership holding assets subject to Code Section 751. See Code Sections 731(a)(1), 751.

form on a tax-free basis. Proponents of the Conversion Proposal note that the more flexible partnership form has become increasingly popular with the enactment of LLC statutes and the promulgation of the check-the-box regulations that became effective in 1997. While the limited partnership form has been available for decades, our anecdotal experience is that until fairly recently there was considerable commercial resistance to operating businesses in unincorporated form. The combination of the broad enactment during the 1990's of state LLC statutes, coupled with the check-the-box regulations, have significantly affected the willingness of participants to engage in business through an LLC. We believe many of these older S corporations would have selected the LLC form had it been available at the time.

On the other hand, it must be observed that a taxpayer is normally bound by his choice of form and not every S corporation covered by the legislation would have necessarily chosen LLC or partnership status at the time of its origination. The shareholders of an S corporation may have selected the corporate form not only because it was the best option for pass-through treatment available at the time, but also perhaps because the founders or employees were more comfortable holding "shares" as opposed to partnership interests and/or because the corporate form would permit a future tax-free reorganization as an "exit strategy." The S corporation form also may be more tax efficient from an employee benefits perspective, because, for example, an S corporation (unlike a partnership) can issue incentive stock options to employees. Moreover, unlike partners in a partnership, S corporation stockholders can dispose of their stock in a capital gain transaction regardless of whether a sale of the underlying assets would produce ordinary income.⁸ In light of the potential advantages of S corporation status, it is not necessarily unfair to require S corporation shareholders to accept the consequences of their choice of entity, including the tax on liquidation, and the Conversion Proposal is arguably over-inclusive in that it would benefit those taxpayers who intentionally selected the S corporation form to maximize tax efficiencies. On balance, however, we believe that the changed commercial circumstances of the past decade favoring a tax-free conversion outweigh any potential detriment as a result of an over-inclusive rule. Accordingly, we support the concept of legislation permitting certain S corporations to convert to an LLC or partnership on a tax-free basis. We note below some collateral implications, as well as

⁸ Compare Code Section 751(a), which treats the amount realized on a sale of a partnership interest as a sale of property other than a capital asset to the extent attributable to unrealized receivables or inventory items.

various technical issues, that would need to be considered in connection with such legislation.

2. Eligibility for Conversion. Under the Conversion Proposal, as drafted, a tax-free conversion is available only if the corporation has had a valid S election continuously in effect for the ten years prior to the conversion.⁹ In our experience the commercial acceptance of operating businesses in unincorporated form has developed over a shorter period than the past ten years. Accordingly, as discussed below we are recommending that the ten-year rule be eliminated. This will require addressing any potential built-in gains tax issues under Code Section 1374 and, more generally, the broader question of whether the Conversion Proposal should apply to an S corporation that was previously a C corporation.

First, take the simpler case of an S corporation without a C corporation history. If the purpose of the Conversion Proposal is to address the fact that the owners would have selected partnership status had the elective classification regime and LLC statutes been available at the date of formation, then the appropriate cut-off date should be some reasonable period (e.g., one year) following the promulgation of the check-the-box regulations. If the S corporation has no C corporation history, we see no reason to impose the additional requirement that the S election has been in effect for at least ten years.

The eligibility issue is significantly more complicated in the case of an S corporation with a C corporation history. Our Committee is divided on this issue. While a majority would permit an S corporation with a C corporation history to convert to partnership status on a tax-free basis, subject to the limitations discussed below, a substantial minority object to such a conversion under all circumstances.

The conversion of an S corporation with a C corporation history implicates both the built-in gains tax under Code Section 1374 and also the tax on passive income under Code Section 1375 imposed on S corporations with C corporation earnings and profits. As we discuss below, these issues can and should be addressed in any legislation. However, the objection to the conversion of an S corporation in this context is based on a more fundamental concern that the fairness arguments in favor of conversion are less

⁹ The 1999 legislation would have permitted a conversion only if the S corporation had a valid S election in effect "for all taxable years of the corporation beginning on or after January 1, 1990." Under this formulation, the S corporation did not necessarily need to be in existence for ten years prior to the conversion.

compelling, because the owners initially formed a C corporation rather than a pass-through entity. Therefore, it is not as clear that the owners would have formed an LLC had it been available at the time.

Another concern is that the conversion of an S corporation with a C corporation history would permit the tax-free distribution of assets once held in corporate form, a result that is arguably inconsistent with the underlying principles of the repeal of the General Utilities doctrine. On the other hand, taxpayers are already permitted under current law to convert from C to S status, so arguably as long as the 1374 issue and the issue of accumulated subchapter C earnings and profits are properly addressed, these corporations should be within the ambit of any legislation.

Regarding the timing of an election, the Conversion Proposal, as drafted, would provide existing S corporations until the end of 2007 to effect the conversion. We would support a more limited opportunity, such as a one-year period after the date of enactment, primarily because we believe this legislation would provide significant benefits to existing S corporations and we see no reason to open the door to additional planning opportunities with an extended election period.¹⁰ We also suggest that, after the conversion, the partnership (or a successor to the S corporation's assets) should not be able to re-elect S corporation status for a prescribed period of time (e.g., five years). Finally, because we do not believe that a conversion should be available to obtain a tax advantage through a change in accounting method, consideration could be given to applying rules similar to Code Section 381 to preserve tax elections in connection with the conversion transaction.

3. Built-In Gains Tax. If an S corporation with a C corporation history is eligible for a tax-free conversion, the law will need to address the implications of the built-in gains tax under Code Section 1374. We believe preserving the built-in gains tax should be an essential component of any legislation in this area. There are several ways to accomplish this objective.

One approach would be to prohibit conversion until the expiration of the applicable ten-year built-in gain period.¹¹ Although simple on its face,

¹⁰ The concern underlying this recommendation is that an S corporation should not be entitled to an extended period in which to elect partnership treatment, while at the same time benefiting from corporate tax provisions.

¹¹ The Conversion Proposal appears to adopt this approach by requiring that an S corporation election is in effect for at least ten years prior to the conversion. However, the precise formulation of the ten-year period in the Conversion Proposal does not conform to the ten-year period in Code Section 1374, and also does not reflect the special rule contained in that section relating to distributions by mutual savings banks. In addition, consistent with (...continued)

this approach raises fairness and policy concerns. While we recommend only a limited window of opportunity for a conversion election, we also believe it would be unfair to deprive an S corporation of the conversion opportunity because its ten-year built-in gains period has not yet expired. However, if the S corporation were granted an extended time period to make an election because of its C corporation history, it would be treated more favorably than a “pure” S corporation. A prohibition on conversions until the expiration of the built-in gain period would likely require complex rules to address these scenarios. For example, we also considered, but rejected as too complex, a rule that would permit the S corporation to convert on a tax-free basis but that would require a tracking of the assets subject to the built-in gain tax, which would maintain their “taint” under Code Section 1374 during the remainder of the ten-year recognition period.

We recommend an alternative approach that would require an S corporation upon conversion to pay the full amount of the built-in gains tax as a “toll charge.” We support this approach not only because of its simplicity, but also because we believe that the opportunity to convert to partnership status on a tax-free basis provides a substantial benefit to existing S corporations with a C corporation history. Therefore, we do not view a “toll charge” on conversion as punitive or unfair.¹²

4. Accumulated C Corporation Earnings and Profits. Under current law, a corporate-level tax is imposed on an S corporation with accumulated C corporation earnings and profits in any year in which more than 25% of the S corporation’s gross income is considered passive income.¹³ This rule is designed to prevent a C corporation that had accumulated earnings at C corporation tax rates from electing S corporation status and holding passive investments, the income of which would be subject to only one level of tax, rather than liquidating the corporation and triggering tax to the shareholders. The Conversion Proposal, as drafted, does not address the implications of the conversion of an S corporation with accumulated C corporation earnings and profits.

(continued...)

the principle that a conversion should not be available if any assets of the S corporation are subject to the built-in gains tax, the Conversion Proposal, as drafted, would need to be modified to prohibit (or otherwise take into account) a conversion in the case of a historic S corporation that acquires assets of a C corporation in a carryover basis transaction.

¹² Presumably the basis of the assets that have built-in gain subject to tax would be increased by the amount of gain recognized.

¹³ Code Section 1375.

Consistent with our recommendation discussed above concerning the Section 1374 tax we believe a “toll charge” is appropriate in this context if S corporations with Subchapter C earnings and profits are included in the conversion legislation. Accordingly, we recommend that any accumulated C corporation earnings and profits should be taxable as a dividend at the time of the conversion.

5. Business Continuity Regime. Under the proposed legislation, the S corporation shareholders must acquire at least 80% of the capital and profits of the resulting partnership. In addition, the resulting partnership must satisfy a continuity of business requirement, similar to that applicable under Code Section 368, for the five consecutive tax years following the year of the conversion.¹⁴ If the continuity of business requirement is not satisfied, the partnership must pay a “corporate conversion recapture tax,” generally calculated by multiplying the tax that would have been imposed on the S corporation liquidation by a fraction representing the portion of the five-year period for which the continuity requirement was not satisfied. If legislation is enacted that incorporates the suggestions made in this letter, *i.e.*, a limited window for electing conversion and toll charges for 1374 gain and subchapter C earnings and profits, it could be argued that this additional requirement is not warranted, particularly in light of the complexities it could entail.

The recapture tax rule could prove complex both from a technical and a policy perspective. For example, the payment of a corporate recapture tax presumably should produce a basis step-up of the partnership’s assets, although this result is not clear under the proposed legislation. Also, because the recapture tax is imposed on the partnership rather than the S corporation shareholders, it might be borne as an economic matter by the “wrong” party if there is a transfer of equity ownership between the date of the conversion and the date the recapture tax is triggered. More fundamentally, it is unclear to us what policy would be served by the continuity of business enterprise requirement. The rule would not effectively prevent divisions of business lines or changes of ownership.

6. Form of Transaction. As a matter of corporate law, the conversion transaction could be accomplished by (i) having the S corporation contribute its assets and liabilities (by way of merger, if provided for under corporate

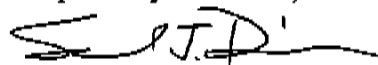
¹⁴ The Conversion Proposal provides that the partnership must either continue “one or more of the S corporation’s historic lines of business,” or use “a significant portion of the S corporation’s historic business assets, whether or not such assets have a taxable basis, in the conduct of an active trade or business.”

law) to a partnership or LLC, followed by a distribution of the partnership interests to the S corporation shareholders in complete liquidation of the S corporation or (ii) having the S corporation distribute its assets and liabilities to its shareholders, followed by a contribution by them of the assets and liabilities to the new partnership. Alternatively, depending on applicable state law, an S corporation may be permitted to convert to an LLC simply by filing a simple form with the state authorities.¹⁵ We have not identified any reason that the form of the transaction should result in different tax consequences. In any event, this is a topic that might be addressed in legislative history (or the statute).

In sum, we recommend that consideration be given to permitting S corporations to convert into partnerships on a tax-free basis, subject to the limitations discussed above. However, there are a number of complexities to the Conversion Proposal and significant policy and revenue issues that should be examined in greater detail before any legislation is finalized.

As always, we would be pleased to discuss these issues with you or members of your staff.

Respectfully submitted,



Samuel J. Dimon
Chair

cc: Lindy L. Paull
Chief of Staff
Joint Committee on Taxation

James D. Clark
Majority Chief Tax Counsel
House Ways & Means Committee

John Buckley
Democratic Chief Tax Counsel
House Ways & Means Committee

¹⁵ See, e.g., Del. Gen. Corp. Law Section 266 (permitting a domestic corporation to convert to a Delaware LLC, limited partnership or business trust by filing a certificate of conversion with the Delaware Secretary of State).



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Senate Finance Committee
United States Senate

511 Hart
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1. Rationale for Conversion Proposal. The basic rationale for the Conversion Proposal is to address the problem faced by individuals who elected S corporation status before the widespread use of LLCs and the availability of the check-the-box regulations.⁵ These S corporations are subject to statutory constraints, including the requirement that an S corporation have only a single class of stock and the limitations on the number and type of S corporation shareholders. While the partnership or LLC form would provide much greater flexibility, under current law the conversion from an S corporation to a partnership or LLC results in a taxable liquidation of the S corporation for federal income tax purposes.⁶ These rules differ from the partnership tax rules, which generally defer tax on a distribution of assets until the date on which the underlying assets are disposed of by the partners, or a partner disposes of its partnership interest.⁷

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On the other hand, it must be observed that a taxpayer is normally bound by his choice of form and not every S corporation covered by the legislation would have necessarily chosen LLC or partnership status at the time of its origination. The shareholders of an S corporation may have selected the corporate form not only because it was the best option for pass-through treatment available at the time, but also perhaps because the founders or employees were more comfortable holding "shares" as opposed to partnership interests and/or because the corporate form would permit a future tax-free reorganization as an "exit strategy." The S corporation form also may be more tax efficient from an employee benefits perspective, because, for example, an S corporation (unlike a partnership) can issue incentive stock options to employees. Moreover, unlike partners in a partnership, S corporation stockholders can dispose of their stock in a capital gain transaction regardless of whether a sale of the underlying assets would produce ordinary income.⁸ In light of the potential advantages of S corporation status, it is not necessarily unfair to require S corporation shareholders to accept the consequences of their choice of entity, including the tax on liquidation, and the Conversion Proposal is arguably over-inclusive in that it would benefit those taxpayers who intentionally selected the S corporation form to maximize tax efficiencies. On balance, however, we believe that the changed commercial circumstances of the past decade favoring a tax-free conversion outweigh any potential detriment as a result of an over-inclusive rule. Accordingly, we support the concept of legislation permitting certain S corporations to convert to an LLC or partnership on a tax-free basis. We note below some collateral implications, as well as

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2. Eligibility for Conversion. Under the Conversion Proposal, as drafted, a tax-free conversion is available only if the corporation has had a valid S election continuously in effect for the ten years prior to the conversion.⁹ In our experience the commercial acceptance of operating businesses in unincorporated form has developed over a shorter period than the past ten years. Accordingly, as discussed below we are recommending that the ten-year rule be eliminated. This will require addressing any potential built-in gains tax issues under Code Section 1374 and, more generally, the broader question of whether the Conversion Proposal should apply to an S corporation that was previously a C corporation.

First, take the simpler case of an S corporation without a C corporation history. If the purpose of the Conversion Proposal is to address the fact that the owners would have selected partnership status had the elective classification regime and LLC statutes been available at the date of formation, then the appropriate cut-off date should be some reasonable period (e.g., one year) following the promulgation of the check-the-box regulations. If the S corporation has no C corporation history, we see no reason to impose the additional requirement that the S election has been in effect for at least ten years.

The eligibility issue is significantly more complicated in the case of an S corporation with a C corporation history. Our Committee is divided on this issue. While a majority would permit an S corporation with a C corporation history to convert to partnership status on a tax-free basis, subject to the limitations discussed below, a substantial minority object to such a conversion under all circumstances.

The conversion of an S corporation with a C corporation history implicates both the built-in gains tax under Code Section 1374 and also the tax on passive income under Code Section 1375 imposed on S corporations with C corporation earnings and profits. As we discuss below, these issues can and should be addressed in any legislation. However, the objection to the conversion of an S corporation in this context is based on a more fundamental concern that the fairness arguments in favor of conversion are less

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Regarding the timing of an election, the Conversion Proposal, as drafted, would provide existing S corporations until the end of 2007 to effect the conversion. We would support a more limited opportunity, such as a one-year period after the date of enactment, primarily because we believe this legislation would provide significant benefits to existing S corporations and we see no reason to open the door to additional planning opportunities with an extended election period.¹⁰ We also suggest that, after the conversion, the partnership (or a successor to the S corporation's assets) should not be able to re-elect S corporation status for a prescribed period of time (e.g., five years). Finally, because we do not believe that a conversion should be available to obtain a tax advantage through a change in accounting method, consideration could be given to applying rules similar to Code Section 381 to preserve tax elections in connection with the conversion transaction.

3. Built-In Gains Tax. If an S corporation with a C corporation history is eligible for a tax-free conversion, the law will need to address the implications of the built-in gains tax under Code Section 1374. We believe preserving the built-in gains tax should be an essential component of any legislation in this area. There are several ways to accomplish this objective.

One approach would be to prohibit conversion until the expiration of the applicable ten-year built-in gain period.¹¹ Although simple on its face,

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this approach raises fairness and policy concerns. While we recommend only a limited window of opportunity for a conversion election, we also believe it would be unfair to deprive an S corporation of the conversion opportunity because its ten-year built-in gains period has not yet expired. However, if the S corporation were granted an extended time period to make an election because of its C corporation history, it would be treated more favorably than a “pure” S corporation. A prohibition on conversions until the expiration of the built-in gain period would likely require complex rules to address these scenarios. For example, we also considered, but rejected as too complex, a rule that would permit the S corporation to convert on a tax-free basis but that would require a tracking of the assets subject to the built-in gain tax, which would maintain their “taint” under Code Section 1374 during the remainder of the ten-year recognition period.

We recommend an alternative approach that would require an S corporation upon conversion to pay the full amount of the built-in gains tax as a “toll charge.” We support this approach not only because of its simplicity, but also because we believe that the opportunity to convert to partnership status on a tax-free basis provides a substantial benefit to existing S corporations with a C corporation history. Therefore, we do not view a “toll charge” on conversion as punitive or unfair.¹²

4. Accumulated C Corporation Earnings and Profits. Under current law, a corporate-level tax is imposed on an S corporation with accumulated C corporation earnings and profits in any year in which more than 25% of the S corporation’s gross income is considered passive income.¹³ This rule is designed to prevent a C corporation that had accumulated earnings at C corporation tax rates from electing S corporation status and holding passive investments, the income of which would be subject to only one level of tax, rather than liquidating the corporation and triggering tax to the shareholders. The Conversion Proposal, as drafted, does not address the implications of the conversion of an S corporation with accumulated C corporation earnings and profits.

(continued...)

the principle that a conversion should not be available if any assets of the S corporation are subject to the built-in gains tax, the Conversion Proposal, as drafted, would need to be modified to prohibit (or otherwise take into account) a conversion in the case of a historic S corporation that acquires assets of a C corporation in a carryover basis transaction.

¹² Presumably the basis of the assets that have built-in gain subject to tax would be increased by the amount of gain recognized.

¹³ Code Section 1375.

Consistent with our recommendation discussed above concerning the Section 1374 tax we believe a “toll charge” is appropriate in this context if S corporations with Subchapter C earnings and profits are included in the conversion legislation. Accordingly, we recommend that any accumulated C corporation earnings and profits should be taxable as a dividend at the time of the conversion.

5. Business Continuity Regime. Under the proposed legislation, the S corporation shareholders must acquire at least 80% of the capital and profits of the resulting partnership. In addition, the resulting partnership must satisfy a continuity of business requirement, similar to that applicable under Code Section 368, for the five consecutive tax years following the year of the conversion.¹⁴ If the continuity of business requirement is not satisfied, the partnership must pay a “corporate conversion recapture tax,” generally calculated by multiplying the tax that would have been imposed on the S corporation liquidation by a fraction representing the portion of the five-year period for which the continuity requirement was not satisfied. If legislation is enacted that incorporates the suggestions made in this letter, *i.e.*, a limited window for electing conversion and toll charges for 1374 gain and subchapter C earnings and profits, it could be argued that this additional requirement is not warranted, particularly in light of the complexities it could entail.

The recapture tax rule could prove complex both from a technical and a policy perspective. For example, the payment of a corporate recapture tax presumably should produce a basis step-up of the partnership’s assets, although this result is not clear under the proposed legislation. Also, because the recapture tax is imposed on the partnership rather than the S corporation shareholders, it might be borne as an economic matter by the “wrong” party if there is a transfer of equity ownership between the date of the conversion and the date the recapture tax is triggered. More fundamentally, it is unclear to us what policy would be served by the continuity of business enterprise requirement. The rule would not effectively prevent divisions of business lines or changes of ownership.

6. Form of Transaction. As a matter of corporate law, the conversion transaction could be accomplished by (i) having the S corporation contribute its assets and liabilities (by way of merger, if provided for under corporate

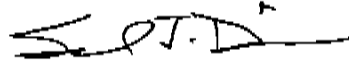
¹⁴ The Conversion Proposal provides that the partnership must either continue “one or more of the S corporation’s historic lines of business,” or use “a significant portion of the S corporation’s historic business assets, whether or not such assets have a taxable basis, in the conduct of an active trade or business.”

law) to a partnership or LLC, followed by a distribution of the partnership interests to the S corporation shareholders in complete liquidation of the S corporation or (ii) having the S corporation distribute its assets and liabilities to its shareholders, followed by a contribution by them of the assets and liabilities to the new partnership. Alternatively, depending on applicable state law, an S corporation may be permitted to convert to an LLC simply by filing a simple form with the state authorities.¹⁵ We have not identified any reason that the form of the transaction should result in different tax consequences. In any event, this is a topic that might be addressed in legislative history (or the statute).

In sum, we recommend that consideration be given to permitting S corporations to convert into partnerships on a tax-free basis, subject to the limitations discussed above. However, there are a number of complexities to the Conversion Proposal and significant policy and revenue issues that should be examined in greater detail before any legislation is finalized.

As always, we would be pleased to discuss these issues with you or members of your staff.

Respectfully submitted,



Samuel J. Dimon
Chair

cc: Lindy L. Paull
Chief of Staff
Joint Committee on Taxation

Russ Sullivan
Majority Chief Tax Counsel
Senate Finance Committee

Mark Prater
Republican Chief Tax Counsel
Senate Finance Committee

¹⁵ See, e.g., Del. Gen. Corp. Law Section 266 (permitting a domestic corporation to convert to a Delaware LLC, limited partnership or business trust by filing a certificate of conversion with the Delaware Secretary of State).



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May 17, 2002

Honorable Pamela F. Olson
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 1334 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Ms. Olson & Mr. Rossotti:

We write to offer our observations concerning legislation introduced last year involving S corporations.¹ On June 27, 2001, Representatives Barbara Cubin and Scott McInnis introduced legislation (H.R. 2337, the "Conversion Proposal") to permit an S corporation that has had a valid S corporation election continuously in effect for ten taxable years to transfer substantially all of its assets to a partnership or limited liability company ("LLC") taxed as a partnership on a tax-free basis, subject to satisfying requirements similar to those applicable to a corporate reorganization. In addition, on October 12, 2001, Representative Jim Ramstad proposed legislation (H.R. 3124, the "Reinvested Gain Proposal") to permit an S corporation to avoid the built-in gains tax that would otherwise apply under Section 1374 of the Internal Revenue Code of 1986 (the "Code"), if the proceeds are used within a specified period of time for certain qualified expenditures (defined broadly to include capital expenditures, deductible

¹ This letter was drafted by Janet B. Korins and Robert Smith, with helpful comments from Andrew N. Berg, Kimberly Blanchard, Samuel Dimon, Robert A. Jacobs, Gary B. Mandel, Michael Schler and Diana Wollman.

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business expenses and payments of principal and interest on debt obligations). More generally, the report prepared by the Staff of the Joint Committee on Taxation regarding proposals to simplify the federal tax system² discusses whether the partnership and S corporation rules should be unified, but offers no recommendation on the issue in part because such a proposal would implicate significant policy issues.

JCT Staff Report. We generally agree with the JCT Staff Report conclusion that efforts to unify the S corporation and partnership regimes would raise competing policy concerns. While it clearly would be simpler to have one pass-through regime rather than the disparate S corporation and partnership rules, implementing the joinder of the rules would be a major project that would introduce technical complexity and raise revenue and policy concerns that may exceed the potential benefits. We have not fully evaluated this issue, but if you decide that this is a project that merits additional consideration we would be pleased to provide more detailed and substantive comments at your request. In any case we believe legislation permitting tax-free conversions of S corporations into LLCs or partnerships is ripe for consideration independent of any broader project on unifying the various pass-through regimes.

Reinvested Gain Proposal. We do not support the Reinvested Gain Proposal because it is fundamentally inconsistent with the purpose of the built-in gains tax imposed by Section 1374, which is designed to prevent the avoidance of corporate-level tax on the conversion of C corporations to S corporations. We see no reason why an S corporation should be permitted to avoid the corporate-level built-in gains tax of Code Section 1374 if sale proceeds are reinvested, while a C corporation would be fully taxed on the same transaction.

Conversion Proposal. The concept of permitting S corporations to convert to partnership status on a tax-free basis is not a new idea. The Clinton administration considered a similar proposal in 1995,³ and legislation substantially similar to the Conversion Proposal was introduced in Congress in 1999.⁴ A majority of our Committee supports legislation to permit certain

² Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, (JCS-3-01), April 2001 (hereinafter, "JCT Staff Report").

³ See "Samuels Suggests Giving Converting S Corporations 'Check-the-Box' Partnership Election," Tax Notes Today, 95 TNT 146-26 (July 27, 1995).

⁴ See S. 1904, introduced in the Senate in 1999 by Senators Craig Thomas and Michael B. Enzi.

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¹⁰ The concern underlying this recommendation is that an S corporation should not be entitled to an extended period in which to elect partnership treatment, while at the same time benefiting from corporate tax provisions.

¹¹ The Conversion Proposal appears to adopt this approach by requiring that an S corporation election is in effect for at least ten years prior to the conversion. However, the precise formulation of the ten-year period in the Conversion Proposal does not conform to the ten-year period in Code Section 1374, and also does not reflect the special rule contained in that section relating to distributions by mutual savings banks. In addition, consistent with (...continued)

this approach raises fairness and policy concerns. While we recommend only a limited window of opportunity for a conversion election, we also believe it would be unfair to deprive an S corporation of the conversion opportunity because its ten-year built-in gains period has not yet expired. However, if the S corporation were granted an extended time period to make an election because of its C corporation history, it would be treated more favorably than a "pure" S corporation. A prohibition on conversions until the expiration of the built-in gain period would likely require complex rules to address these scenarios. For example, we also considered, but rejected as too complex, a rule that would permit the S corporation to convert on a tax-free basis but that would require a tracking of the assets subject to the built-in gain tax, which would maintain their "taint" under Code Section 1374 during the remainder of the ten-year recognition period.

We recommend an alternative approach that would require an S corporation upon conversion to pay the full amount of the built-in gains tax as a "toll charge." We support this approach not only because of its simplicity, but also because we believe that the opportunity to convert to partnership status on a tax-free basis provides a substantial benefit to existing S corporations with a C corporation history. Therefore, we do not view a "toll charge" on conversion as punitive or unfair.¹²

4. Accumulated C Corporation Earnings and Profits. Under current law, a corporate-level tax is imposed on an S corporation with accumulated C corporation earnings and profits in any year in which more than 25% of the S corporation's gross income is considered passive income.¹³ This rule is designed to prevent a C corporation that had accumulated earnings at C corporation tax rates from electing S corporation status and holding passive investments, the income of which would be subject to only one level of tax, rather than liquidating the corporation and triggering tax to the shareholders. The Conversion Proposal, as drafted, does not address the implications of the conversion of an S corporation with accumulated C corporation earnings and profits.

(continued...)

the principle that a conversion should not be available if any assets of the S corporation are subject to the built-in gains tax, the Conversion Proposal, as drafted, would need to be modified to prohibit (or otherwise take into account) a conversion in the case of a historic S corporation that acquires assets of a C corporation in a carryover basis transaction.

¹² Presumably the basis of the assets that have built-in gain subject to tax would be increased by the amount of gain recognized.

¹³ Code Section 1375.

Consistent with our recommendation discussed above concerning the Section 1374 tax we believe a “toll charge” is appropriate in this context if S corporations with Subchapter C earnings and profits are included in the conversion legislation. Accordingly, we recommend that any accumulated C corporation earnings and profits should be taxable as a dividend at the time of the conversion.

5. Business Continuity Regime. Under the proposed legislation, the S corporation shareholders must acquire at least 80% of the capital and profits of the resulting partnership. In addition, the resulting partnership must satisfy a continuity of business requirement, similar to that applicable under Code Section 368, for the five consecutive tax years following the year of the conversion.¹⁴ If the continuity of business requirement is not satisfied, the partnership must pay a “corporate conversion recapture tax,” generally calculated by multiplying the tax that would have been imposed on the S corporation liquidation by a fraction representing the portion of the five-year period for which the continuity requirement was not satisfied. If legislation is enacted that incorporates the suggestions made in this letter, *i.e.*, a limited window for electing conversion and toll charges for 1374 gain and subchapter C earnings and profits, it could be argued that this additional requirement is not warranted, particularly in light of the complexities it could entail.

The recapture tax rule could prove complex both from a technical and a policy perspective. For example, the payment of a corporate recapture tax presumably should produce a basis step-up of the partnership’s assets, although this result is not clear under the proposed legislation. Also, because the recapture tax is imposed on the partnership rather than the S corporation shareholders, it might be borne as an economic matter by the “wrong” party if there is a transfer of equity ownership between the date of the conversion and the date the recapture tax is triggered. More fundamentally, it is unclear to us what policy would be served by the continuity of business enterprise requirement. The rule would not effectively prevent divisions of business lines or changes of ownership.

6. Form of Transaction. As a matter of corporate law, the conversion transaction could be accomplished by (i) having the S corporation contribute its assets and liabilities (by way of merger, if provided for under corporate

¹⁴ The Conversion Proposal provides that the partnership must either continue “one or more of the S corporation’s historic lines of business,” or use “a significant portion of the S corporation’s historic business assets, whether or not such assets have a taxable basis, in the conduct of an active trade or business.”

law) to a partnership or LLC, followed by a distribution of the partnership interests to the S corporation shareholders in complete liquidation of the S corporation or (ii) having the S corporation distribute its assets and liabilities to its shareholders, followed by a contribution by them of the assets and liabilities to the new partnership. Alternatively, depending on applicable state law, an S corporation may be permitted to convert to an LLC simply by filing a simple form with the state authorities.¹⁵ We have not identified any reason that the form of the transaction should result in different tax consequences. In any event, this is a topic that might be addressed in legislative history (or the statute).

In sum, we recommend that consideration be given to permitting S corporations to convert into partnerships on a tax-free basis, subject to the limitations discussed above. However, there are a number of complexities to the Conversion Proposal and significant policy and revenue issues that should be examined in greater detail before any legislation is finalized.

As always, we would be pleased to discuss these issues with you or members of your staff.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'S. J. Dimon', written over a horizontal line.

Samuel J. Dimon
Chair

cc: Eric Solomon
Robert P. Hanson
Honorable B. John Williams, Jr.

¹⁵ See, e.g., Del. Gen. Corp. Law Section 266 (permitting a domestic corporation to convert to a Delaware LLC, limited partnership or business trust by filing a certificate of conversion with the Delaware Secretary of State).