
House Ways and Means Committee releases pass-through tax reform discussion draft

March 12, 2013

In brief

House Ways and Means Committee Chairman Dave Camp (R-MI) today issued a “small business” tax reform discussion draft that features proposals affecting large and small partnerships and S corporations.

The discussion draft includes a proposal to provide a new uniform rule limiting the use of the cash method of accounting to businesses with gross receipts of \$10 million or less.

The discussion draft offers two options to modernize the tax treatment of partnerships and S corporations: (Option 1) revisions to Subchapter K and Subchapter S; or (Option 2) a new, unified pass-through regime.

A seven-page [summary](#) of the discussion draft identifies several unaddressed issues on which comments are requested, including transition rules and the treatment of mergers, divisions, and reorganizations with respect to a new unified pass-through regime (Option 2). The Ways and Means Committee also released 134-pages of [draft statutory text](#) and a 70-page [technical explanation](#).

Chairman Camp stated that the pass-through reforms will be considered by the Ways and Means Committee as part of a broader, comprehensive tax reform package that “significantly lowers rates for individuals, small businesses, and corporations.”

Interested parties are encouraged to submit comments to the committee staff and a Ways and Means small business/pass-through tax reform working group, which is chaired by Rep. Vern Buchanan (R-FL) and vice-chaired by Rep. Allyson Schwartz (D-PA). There is an April 15, 2013 deadline to submit comments to the bipartisan tax reform working groups, with a final Joint Committee on Taxation staff report to be delivered by May 6, 2013.

Action this year on comprehensive tax reform is assumed in the proposed House budget resolutions released earlier today by House Ways and Means Committee Chairman Paul Ryan (R-WI). For more details on House Republican tax reform principles, see the March 12 “[WNTS Insight – House Republican budget calls for business and individual tax reform](#).”

In detail

Pass-through simplification proposals

The Ways and Means small business discussion draft includes several proposals intended to “simplify tax compliance for small businesses.” Some of these proposals would affect both large and small pass-through entities.

Key simplification proposals include the following:

- Provide permanent section 179 expensing of investments in new equipment and property, up to \$250,000, with the deduction phased out for investments exceeding \$800,000. The draft also makes permanent the current temporary provisions allowing computer software and certain investments in real property to qualify for section 179 expensing.
- Provide a new uniform rule under which all businesses with gross receipts of \$10 million or less may use the cash method of accounting.
- Establish a new unified deduction for start-up and organizational expenses of all businesses. The draft would repeal the separate special rules relating to the organizational costs of corporations and partnerships.
- Provide new due dates for business tax returns, including corporate and non-corporate returns, to “ease tax compliance.”

Partnership and S corporation tax reform options

The discussion draft offers two options to modernize the tax treatment of partnerships and S corporations: (1) revisions to

Subchapter K and Subchapter S; or (2) a new, unified pass-through regime.

Option 1 revisions to Subchapter K and Subchapter S

Option 1 incorporates a number of proposals from the S Corporation Modernization Act (H.R. 892) intended to provide “greater flexibility” to S corporations in their day-to-day operations. Option 1 also includes proposals to eliminate certain perceived tax abuses in Subchapter K, to clarify certain partnership rules, and to align certain partnership rules with S corporation rules.

Partnership proposals included in Option 1:

- Repeal the rules relating to guaranteed payments to partners, treating payments received by partners as either payments in their capacity as partners (i.e., part of their distributive shares of partnership income or loss) or in their capacity as non-partners.
- Require all partnerships to adjust the tax basis in partnership property when the partnership distributes property to a partner or a partner transfers the partner’s interest in the partnership, with corresponding adjustments in cases involving tiered partnerships.
- Adjust the limitation on a partner’s share of losses to take into account charitable contributions and foreign taxes, conforming the partnership rules to the S corporation rules and thus preventing a partner from deducting losses in excess of basis.
- Clarify that all distributions of inventory items are treated as a sale or exchange between the partner and the partnership,

eliminating the requirement that inventory be substantially appreciated in value to trigger gain recognition.

- Require that partners contributing property with a built-in gain be subject to tax on the pre-contribution gain when the partnership distributes such property to another partner or the partnership distributes other property to the contributing partner. The proposal eliminates the current seven year time period for recognition of such pre-contribution gain.

S corporation proposals included in Option 1:

- Permanently reduce to five years (from ten years) the period following a conversion from C corporation status to S corporation status during which an S corporation must pay the highest corporate tax rate on certain built-in capital gains. In addition, the proposal makes permanent the rule that installment sales are governed by the provision applicable in the tax year when the sale was made.
- Increase to 60 percent (from 25 percent) the portion of an S corporation’s income that may be passive without incurring an entity-level tax, and eliminate the current rule that terminates an S corporation’s pass-through status if it has excess passive income or accumulated earnings and profits for three consecutive years.
- Permit non-resident aliens to be S corporation shareholders through a US electing small business trust (“ESBT” – a type of trust that is permitted to own stock of an S

corporation), intended to better align the S corporation rules with the partnership rules. Accordingly, the trust must withhold tax on income earned from the S corporation, thus ensuring that non-resident aliens are subject to US tax on their shares of S corporation income.

- Allow an ESBT to deduct charitable contributions made by the S corporation subject to the contribution limits and carryover rules applicable to individual donors.
- Modify the shareholder basis adjustment rules for S corporations making charitable contributions. This proposal conforms the S corporation rules to partnership rules and provides a fair market value deduction for a charitable contribution, but limits the decrease in the shareholder's stock basis to the adjusted basis of the contributed property.
- Simplify the procedure and extend the time for making an S corporation election, permitting a corporation to make the election on its first tax return.

Option 2 for a new, unified pass-through regime

Option 2 in the discussion draft would repeal current law Subchapter K and Subchapter S and provide a "simple, uniform set of rules" that would apply to non-publicly traded businesses for Federal tax purposes regardless of how the business is organized at the state level.

New rules under Option 2 include proposals to:

- Treat corporations that currently qualify as S corporations as a "pass-through entity" under new Subchapter K.

- Encourage the formation of new businesses by allowing contributions of property and money on a tax-free basis.
- Maintain the pass-through of items of income, gains, losses, and credits, so that such items have the same character in the hands of the owners that they have in the hands of the entity.
- Reduce the use of complex structures to "engage in tax avoidance" by permitting only net ordinary income or loss, net capital gain or loss, and tax credits to be specifically allocated to owners.
- Require entity-level withholding on the pass-through entity's income and gain with a corresponding credit to the owner to "close the tax gap" and "simplify" withholding responsibilities, including treating the actively participating owners of pass-through entities as employees.
- Limit the deductions for losses (including charitable contributions and foreign taxes) to an owner's tax basis in the pass-through entity, but allow excess losses to be carried forward indefinitely.
- Ensure that taxes are paid on "real, economic gains (but not on returns of capital)" by limiting tax-free distributions to the owner's basis in the business. This proposal requires the owner of the pass-through entity to recognize gain on any distribution of property to the extent the fair market value of the property exceeds the owner's tax basis in the pass-through entity.
- Prevent the use of pass-through entities to "shift gains and losses" among owners with different tax profiles by (1) requiring pass-

through businesses to recognize gain on all distributions of appreciated property and (2) preserving losses in distributed property by requiring owners to take carryover basis in the distributed property. As under option 1, the seven year time period for the recognition of pre-contribution gains would be eliminated.

- Conform the basis rules for S corporations to the basis rules for partnerships by allowing owners to increase the tax basis of their ownership interests for entity-level debt (both recourse and non-recourse).
- Require all pass-through entities to adjust the basis of its assets when the entity distributes property or an interest in the entity is transferred.
- Preserve the character of gains and losses on contributed property.

Request for Comment

The discussion draft identifies certain technical and policy issues that may need to be resolved as part of comprehensive tax reform legislation.

Comments are requested on several issues that are not addressed in the discussion draft, including:

- Employment and self-employment taxes of partners and shareholders, both under Option 1 and Option 2.
- The effect of the proposed threshold for cash accounting on other provisions of the tax code not directly related to accounting methods.
- Transition rules necessary to facilitate the adoption of new proposals by existing small businesses and pass-through

entities, with a goal of minimizing the burden on the owners.

- The proper treatment of foreign partners in US partnerships, US partners in foreign partnerships, and tax-indifferent owners under Option 2.
- Other ways to coordinate and modernize Subchapter K and Subchapter S to minimize disparate treatment of partner and S corporation shareholders.

The takeaway

Ways and Means Chairman Camp has invited “stakeholders” to review and comment on the small business discussion draft and to share feedback

with committee staff and the tax reform small business/pass-through working group.

The Ways and Means Committee previously released tax reform discussion drafts on international tax issues in late 2011 and on financial products earlier this year. For more details on these previous discussion drafts, see the November 1, 2011 “[WNTS Insight – Ways and Means Chairman Camp releases discussion draft for corporate rate reduction, territorial tax system](#),” and the February 12, 2013 “[WNTS Insight – Ways and Means ‘Discussion Draft’ proposes major changes to taxation of financial products](#).”

Chairman Camp has noted that these discussions drafts are intended to provide opportunity for input as the Ways and Means Committee prepares to act on a comprehensive tax reform bill for consideration by the full House this year.

It remains uncertain whether Congress and President Obama can agree on tax reform legislation, but there has been substantial bipartisan interest in enacting tax reform, both to promote economic growth and address federal budget deficits. As a result, the prospects of significant tax reform legislation being enacted should be carefully considered as businesses and individuals review the Ways and Means discussion drafts and provide input to tax policymakers.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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