John K. McNulty

WHY SUBCHAPTER S (PARTNERSHIP TAX TREATMENT FOR CLOSELY-HELD ELECTING CORPORATIONS) SHOULD BE RETAINED EVEN IF INTEGRATION BY SOME OTHER METHOD IS ENACTED IN THE UNITED STATES

This commentary argues for the retention of a significant role for Subchapter S even if and after a general integration regime has been adopted. I favor integration in general.

1 Roger J. Trayner Professor of Law, University of California, Berkeley School of Law (Boalt Hall).


3 Often it is said that the United States has a classical, unintegrated system of corporate taxation. See, e.g., Malcolm Gammie, Reforming Corporate Taxation: An Evaluation of the United States Treasury Integration Proposals and other Corporate Tax Systems in an International Context (pt. 2), 1992 BRIT. TAX REV. 243. More correctly put, the United States has that system plus an elective, complete, pass-through integration system for U.S. owned, single-class stock companies with 35 or fewer individual shareholders. IRC §§1361-1378. Furthermore, the “corporate,” second tax is imposed on publicly-traded, limited partnerships, and on other non-corporate entities that resemble a corporation. IRC §§7701(a)(3), 7704(a). So, the question becomes why not retain the Subchapter S part of the system when and if Congress modifies the part that taxes other companies in the classical manner?

Treasury has unveiled its recommendation for integrating the corporate and individual income taxes. Treasury Dep’t, A Recommendation for Integration of The Individual and Corporate Tax Systems (1992) [hereinafter Treasury Legislative Proposal] and a letter from Nicholas F. Brady, Secretary of the Treasury, to The Honorable Dan Rostenkowski, Chairman of the Committee on Ways and Means (Dec. 11, 1992), reprinted in DAILY TAX REPORT (BNA), Dec. 14, 1992, at L-7.

The shareholder allocation prototype that Treasury outlined and discussed but, unfortunately, did not recommend for further study, differs from Subchapter S in some important respects, including retention of a tax on the entity, one that is allocated to shareholders for credit against their personal tax liabilities. Furthermore, it denies a pass-through for losses. This prototype would not be limited to closely-held or one-class-of-stock entities. Treasury disavowed this allocation prototype because it would not invariably collect at least one tier of U.S. tax on foreign-source income or tax-preferred corporate income. Treasury Dep’t, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once 27-37 (1992) [hereinafter Treasury Report].
If the United States adopts some form of corporate tax integration, a retained Subchapter S could, and I believe should, continue in either an ALI shareholder imputation credit world or in a Treasury dividend exclusion or CBIT world.

I. THE MERITS OF SUBCHAPTER S

United State tax lawyers and academics are fond of Subchapter S. It is a very good system in theory and in practice, and it is better than anything else proposed, at least for single-stock, closely-held U.S. corporations. It is also the best model for evaluating other systems that would integrate the corporate and individual income tax.

Subchapter S can be compared with Subchapter K (partnership taxation) in the United States as a model for complete integration of the corporate tax and it is superior to the major integration prototypes, because it is closest to a “straight-up allocation model.” Treasury imposed restrictive or predetermining conditions on itself, and the Treasury Report, in some respects, does not even

The Treasury Report probably was driven by a strong impulse to close the tax differences between equity and debt, and by the overleveraging of the 1980's. Lee A. Sheppard, Tax Officials Discuss Integration, Future Legislation at ABA Meeting, 46 TAX NOTES 756 (Feb. 12, 1990). See generally Michael J. Graetz, The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions, 42 TAX NOTES 721 (Feb. 6, 1989); J. Andrew Hoerner, Tax Bar Prepares for Treasury's Corporate Integration Report, 47 TAX NOTES 778 (May 14, 1990); Alvin C. Warren Jr., Recent Corporate Restructuring and the Corporate Tax System, 42 TAX NOTES 715 (Feb. 6, 1989).

Probably also it was very concerned with the difference between taxation of dividends and of other, dividend-like, distributions, such as redemption of shares. See generally Anne L. Alstott & James B. Mackie, Approaches to Corporate Integration: The Treasury Department Report, 45 NAT'L TAX J. 209 (1992); Geraldine Gerardi, Michael J. Graetz & Harvey S. Rosen, Corporate Integration Puzzles, 43 NAT'L TAX J. 307 (1990); Jasper L. Cummings Jr., ‘Taxing Business Income Once’: Where’s the Beef? A Review and Critique of the Treasury Integration Study, 54 TAX NOTES 1391 (Mar. 16, 1992); Richard Goode, Integration of Corporate and Individual Taxes: A Treasury Report, 54 TAX NOTES 1667 (Mar. 30, 1992); Gene Steuerle, Two Cheers for the Treasury Integration Study, 54 TAX NOTES 331 (Jan. 20, 1992).


5 Treasury Report, note 3 at 17-25, 39-60.

6 For a discussion of these topics, see Deborah H. Schenk, Commentary, Complete Integration in a Partial Integration World, 47 TAX L. REV. 697 (1992).

7 See Ginsburg, note 2, at 669-71.

8 Id. at 678.
accord with its own goals.\textsuperscript{9} The straight-up allocation model, or Subchapter S model, is the theoretically correct integration model, one to implement whenever possible and to use as a standard for evaluating other proposals.\textsuperscript{10}

The most important reason to regard S integration as superior is that it is fundamentally a system of complete integration, while the other major proposals fundamentally provide only dividend relief, not complete "integration."\textsuperscript{11} Complete integration means integration for retained as well as distributed earnings, but "dividend relief" (or "partial integration") is a term applicable to relief for distributed earnings only.\textsuperscript{12} Moreover, truly complete integration should mean integration for negative income \(-\text{losses}\) as well as for positive, taxable profits. Subchapter S integrates losses as well as both distributed and

\textsuperscript{9} Id. at 679-80.

\textsuperscript{10} To be sure, I earlier touted the Carter Commission version of a shareholder imputation credit integration plan. I believe in it, at least if S integration is not feasible for all corporations, particularly because it includes a voluntary allocation of undistributed earnings that brings it close to a subchapter S approach. John K. McNulty, Reform of the Individual Income Tax by Integration of the Corporate Income Tax, 46 Tax Notes 1445 (Mar. 19, 1990) [hereinafter Reform].


\textsuperscript{11} The ALI option for constructive dividend and recontribution, ALI Reporter's Study, note 4, at 105-06 (Proposal 5), and Treasury's Dividend Reinvestment Plan (D.R.I.P.), Treasury Report, note 3, at 87-88, do allow for the possibility of elective "integration" for undistributed earnings, but not as the usual or default position, and they do not pass through losses. Treasury's shareholder allocation prototype would allocate corporate income to shareholders. Id. at 27-37.

S integration is even better than the Treasury shareholder allocation method, which is not a full partnership method or "transparency" system of integration because, for example, losses pass through to shareholders.

undistributed profits. Thus, it comes closest to the kind of "straight-up allocation model" U.S. theorists and economists admire so much. With this perspective, Subchapter S seems preferable to the two main Treasury models and even to the excellent ALI construct, as a theoretical matter, although it (the ALI proposal, one very close to the Canadian Carter Commission recommendations) may be the best feasible approach. It surely seems preferable to both the Treasury CBIT and dividend exclusion proposals.

II. THE SUPERIORITY OF S INTEGRATION OVER OTHER METHODS

Why is it that Subchapter S, or the nearest thing to it, such as the Carter Commission or ALI proposals, stands head and shoulders above CBIT and dividend exclusion (or dividend deduction/split rate versions, in use in Germany, Japan from 1961-1989, and elsewhere and recommended by Treasury in 1984 and the President in 1985)? The answer, in my mind, derives from the view that business income finally should be taxed to the owners of the business, at their rates, at appropriate times. This view embraces, in other words, the fundamental theory of our individual income tax. It is a tax that is a personal tax, one that takes a global (not a schedular) approach to its base and rates and, as a general principle, one that lumps all of a taxpayer's financial gains together in one quantity and then taxes that amount according to Congress' notions of "ability to pay" —the ability to pay of each individual taxpayer, as determined by his relevant financial, social and tax characteristics. Because only individuals can consume, or benefit from consumption, only individuals bear the incidence or burden of any tax, and it is this burden that should be geared to ability to pay (somehow rightly conceived) of the individual bearers. Ideally, all income would

---

13 IRC §1366(a)(1).
14 Even the shareholder allocation prototype constructed by Treasury is not a pure pass through model. See note 2.
15 4 Canada, Royal Commission on Taxation, Report 82-93.
16 The ALI Reporter, Professor Alvin C. Warren, also has shown appreciation for the Carter Commission model, and wisely has incorporated elements of it in his ALI draft. See Warren, note 10; Alvin C. Warren Jr., Taxing Corporate Income in the U.S. Twenty Years After the Carter Co Commission: Integration or Disintegration?, 4 AUSTRALIAN TAX F. 465 (1987).
and should be taxed to individuals, and only to individuals.

Thus, if one takes the basic philosophy, structure and theory of the individual income tax seriously, one probably would prefer to tax undistributed corporate income to shareholders by taxing unrealized appreciation (and diminution) in the value of shares as an accretion to net worth, \textit{à la} the von-Schanz/Haig-Simons\textsuperscript{21} conceptions of income.\textsuperscript{22} However, the realization rule, part of the U.S. income tax’s genetic code, and the practicalities it represents, make accretion taxation of unrealized share gains and losses unworkable for most corporations.\textsuperscript{23} Yet, if the corporation’s earnings are not taxed to shareholders until distribution, the deferral or avoidance possibilities will be unacceptable. Consequently, a separate corporate income tax has evolved as a surrogate for (theoretically correct) current taxation of shareholders, lest undistributed corporate earnings go entirely untaxed for too long.

This perspective emphasizes that the United States has an income tax on corporations in the classical mold because of the rule of realization, without which there could be annual taxation of accretions or diminutions in value of shares, the right way for the individual income tax to tax shareholders. There is a separate tax on corporations only as a kind of surrogate, because of the inability, or the unwillingness, to try to tax shareholders on an accretion basis. The corporate tax system serves as a collection mechanism for the personal tax system.\textsuperscript{24}

So, in this view, the corporate income tax is really just something designed to aid and perfect the individual income tax. It includes undistributed corporate sector earnings in the income tax base only in a crude and brute way and it overtaxes distributed corporate earnings.\textsuperscript{25} Consequently, the Subchapter S


\textsuperscript{24} See Gammie, note 22, at 157.

\textsuperscript{25} To be sure, taxing a corporation’s earnings to it at its rate does not do the same thing as taxing unrealized accretions or diminutions in share values, and dividends to the
integration model, which taxes business income of Subchapter S corporations the way it would be taxed if the business were a proprietorship or a partnership, strikes one as right, as an integration model, and as a desirable real-world system operating wherever it can be used. It accords with all of our values about individual income taxation. That is to say, it promotes progressivity, fairness and horizontal and vertical equity and takes a global rather than a schedular definition of income.\textsuperscript{26} It is sensitive to rate, status and other individual characteristics of individual shareholders. These are some things the two main Treasury proposals do not do.\textsuperscript{27} S integration also provides, for these reasons and others, the fairest method of integration, regardless of assumptions about the incidence of the income tax, an aspect that receives little attention in the Treasury Report.

Depending on their basis rules and capital gain taxes,\textsuperscript{28} the ALI and Treasury models still may differentiate between retained and distributed earnings in important ways. Consequently, either of these models would constitute a suboptimal improvement.

Subchapter S integration also should provide the most efficient allocation of resources between incorporated and unincorporated sections of the economy, that is to say it provides neutrality and economic efficiency. It is close to neutral with respect to the distribution or retention of earnings and as to debt versus equity capitalization of firms.\textsuperscript{29} It also is reasonably efficient fiscally. It is

shareholders at their rates. Nor is a pass-through approach to integration the same thing as taxing unrealized share gains and losses, because changes in share values do not exactly equal retained earnings, though the two values tend to move together. Among the tax substitutes for von Schanz-Haig-Simons accrual taxation, the Subchapter S approach seems far superior on theoretical grounds to either the unintegrated classical approach or to a schedular (Treasury) or other partial integration model.

\textsuperscript{26} The models that Treasury recommended surreptitiously introduce a distinction between income from capital and income from labor. See, e.g., Treasury Report, note 3, at 42.

\textsuperscript{27} The Treasury recommendations do not so much propose to integrate the two taxes, as that term usually means both ensuring that only a single tax will be applied and that it will be levied at the shareholders' marginal rates, as they simply tend to lay a flat rate tax on capital income that takes the form of corporate profits. Gammie, note 3, at 250. The ALI proposal, in contrast, does attempt to attain both aspects of integration.

\textsuperscript{28} For a comprehensive discussion of these issues, see Michael L. Schler, \textit{Taxing Corporate Income Once or (Hopefully) Not at All}, 47 \textit{TAX L. REV.} 509 (1992).

\textsuperscript{29} Treasury's CBIT would equalize debt and equity by denying a deduction for interest (just as dividends are nondeductible), and excluding interest and dividends from recipients' income. Treasury Report, note 3, at 39. This neutrality may be said to go further than S accompanied by an interest deduction.

A recent study by two Treasury economists indicates that a CBIT type integration would have a strong effect on overall foreign asset holdings in the United States, resulting in a drop in the U.S. capital stock. Because CBIT denies an interest deduction, interest rates paid on U.S. debt would be expected to fall and foreign capital, being mobile, would flow elsewhere. The study indicates that a full integration or dividend credit
SUBCHAPTER S

relatively neutral as between the choice of form: proprietorship, partnership, S corporation or limited liability company, the coming phenomenon and a very important development on the choice-of-form scene. Moreover, if there is not retention and expansion of subchapter S, limited liability companies will substitute for S corporations. Treasury’s CBIT plan would, presumably, override them, as it would override Subchapter S and the present proprietorship and partnership regimes, but the dividend exclusion plan apparently would not do so.

When thinking about junking Subchapter S, we must remember also that the United States has long and valuable experience with it, not only at the Federal level, but also among the states. Some states have adopted an analogue and other states have learned how to operate their own systems in a world where corporations are able to elect Subchapter S at the national level, or in other states. That experience ought not to be set aside lightly.

In other words, Subchapter S correctly taxes all business income, including losses (negative income) on a comprehensive income tax approach; that is not true of the proposals of either the ALI Reporter’s Study or the Treasury Report.

Subchapter S also provides a tremendously desirable form or model of integration, because it is robust as to income tax rate changes and rate relationship changes. The other integration prototypes under consideration are immensely vulnerable, in varying degrees, if rate relationships (for example between top individual and corporate rates) change a good deal, or even a little. As a consequence, the Treasury’s two main models, and even the ALI approach, might

approach, in contrast, would not have this overall effect; although these plans would induce a decline in foreign holdings of U.S. equity, there would be an increase in foreign holdings of U.S. debt. Corporate Integration Options May Alter Mix, Level of Foreign Investment in U.S., Daily Tax Report (BNA), Oct. 13, 1992, at G-4 to G-5.


32 We also have experience, at the federal level, with other pass-through or allocation systems, including Subchapter K and Subpart F, applicable to foreign subsidiaries. See generally James S. Eustice, Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals), 39 TAX L. REV. 345 (1984). Moreover, proposed legislation would make the undistributed income of all subsidiaries of U.S. multinationals currently taxable by the United States. H.R. 5270, 102d Cong., 2d Sess. §201 (1992).

33 Corporate tax rates, at least, are likely to change in response to rates in other countries, because of increasingly internationalized capital markets. Individual income tax rates can be set by each country more autonomously.
tend to lock in the existing rate relationships, a considerable loss of national public policy flexibility. Subchapter S just does not do that damage.

Also, compared to Treasury's integration models at least, Subchapter S provides outside (shareholder) basis adjustments for the pass through of income and losses. The system of basis and taxation of gains (or losses) is important when shareholders in an integrated system sell or dispose of their shares, in order to prevent "too much" or "too little" integration from resulting. In fact, it seems that some aspects of these problems have not been adequately worked out for other integration models, but Subchapter S has a fine scheme, and historical record, on this score. More particularly, under Subchapter S, when income (capital gains) tax is imposed upon the sale of shares, there is not double taxation of retained profits, as would be the case under Treasury's dividend exclusion prototype or CBIT unless a dividend reinvestment plan, with basis consequences, had been elected with respect to all retained earnings.

Subchapter S should be retained because it is a superior system.

III. WHY SUBCHAPTER S SHOULD BE RETAINED IN AN OTHERWISE INTEGRATED WORLD

Interestingly enough, Treasury has decided to recommend legislation that would install a dividend exclusion method of integration for all corporations except S corporations. This plan would allow-partnerships, electing S corporations and other pass through entities to remain governed by Subchapters K and S as at present. Treasury recommends retaining Subchapter S even though to do so is "somewhat inconsistent with our long-term policy preference for a schedular tax on enterprise activity and our goal of tax simplification." It does so because the alternative regimes are so deeply embedded in the system that any other approach would prove exceedingly disruptive and would require elaborate transition rules. Treasury implied that conversion to a CBIT later would be desirable and would entail repealing Subchapter S.

Why should the U.S. retain Subchapter S specifically in a world that adopts some form of dividend relief for other, non-S corporations? One reason, implied by the foregoing, is because it is a superior system for the corporations and investors to whom it does apply. Therefore, why make them use something else—a dividend exclusion or a dividend relief regime? Let them use Subchapter S, if they opt for it, at least, which is the better thing to do. In addition, think that it ought to be retained if there is to dividend relief, in some form or another, with the hope of expanding Subchapter S.

To press further the question of why to retain Subchapter S in a world

---

35 See generally, Schler, note 28.
36 Income of an S corporation passes through and is reported by the shareholders whether or not it is distributed, IRC §1366(a), and increases the basis of the shares, IRC §1367(a), thus preventing further gain when they are sold.
with dividend relief, think about what entities and investors would want to elect Subchapter S treatment instead of the new partial integration system. For example, suppose the United States enacted Treasury’s dividend exclusion model and suppose that, for the moment, existing rate relationships still prevailed. Surely businesses that wanted to incorporate yet wanted to be able to pass through losses would prefer Subchapter S, that is, either start-up or high-risk or just ordinary businesses. Any business that wanted, or would need, to retain much of its earnings and whose shareholders had marginal tax than the corporation’s top rate would prefer to be able to elect Subchapter S. If individual rates rose significantly above the top corporate rate, high-bracket shareholders would prefer the dividend exclusion system and liberal tax reformers would criticize the dividend exclusion model for enabling “fat cats” to shelter undistributed profits from high individual rates. That situation would put pressure on several things: the capital gains rate differential, non-dividend distributions, §1014 and any other escape from tax on unrealized appreciation, the debt/equity distinction, the corporate resemblance test, the accumulated earnings surtax, the personal holding company tax and the foreign personal holding company tax, not to speak of foreign tax haven planning.

Suppose instead that the admirable ALI proposal were enacted. It would give total relief from “double tax” on distributed or allocated (constructively distributed) profits. Even so, loss businesses would prefer to be able to elect Subchapter S, or would be forced into the partnership mold or would leap into limited liability company form. And businesses that wanted to retain profits would wish that lower individual rates (maximum 31%) would apply during the period of retention, rather than the higher corporate rate (maximum 34%). If the corporate rate went still higher, in comparison with the top (if applicable) individual rate, this effect would become even more pronounced. One solution would be to “allocate” (Carter Commission language) or “constructively distribute” (D.R.I.P.!) the retained earnings.

In contrast, if individual rates went much higher than the top (or applicable) corporate rate, retained earnings would not be allocated or distributed voluntarily. The tax law would create a disincentive to distribution, as at present (in the “traditional view”). It also would allow taxpayers a choice of paying whichever rate were lower, if profits could be retained but either “allocated” or

37 Admittedly, perhaps some corporations unlikely to suffer loss but wanting often to retain earnings would be indifferent between S integration and dividend exclusion with the dividend re-investment plan, or might even prefer the latter if it could be turned on and off more easily than an S election could be made, revoked and made again.

38 To be sure, if a Carter Commission voluntary allocation or ALI constructive dividend easily could be chosen or not, retention corporations that predicted no losses might even prefer the ALI model to subchapter S integration, since the S election cannot so readily be made, unmade and made again.

not. Mandatory, or elected, Subchapter S would allow less game playing and would be neutral with respect to actual distributions, more so even than the ALI/Carter Commission system.

Now let us suppose that Treasury's CBIT were enacted. For the moment, also assume that present rate relationships survived. Loss corporations would prefer Subchapter S, as would businesses with unused losses from pre-incorporation, pre-CBIT years, in order to use those losses against the business' future profits. Again, in a profitable corporation, high-income shareholders would prefer to have their own individual rates apply, rather than the entity's still-higher corporate rates, but they could not accomplish that without an available S election.

Then imagine that individual rates parted company with corporate rates by a significant margin. Movement in either direction would mean that business income of an individual would be taxed at very different rates from other income, including salary or rents and royalties. Great pressure would be put on the line between dividends and interest (both nondeductible and excludable and therefore taxed at schedular corporate rates under CBIT) and wages, rents or royalties (deductible, but not excludable and therefore taxed at individual rates). If these rate relationships flip flopped, taxpayers and tax planners either would thrive on the need for reversing their planning or would cry for stability and good old Subchapter S. If the rate relationship were far from parity, but remained stable, the fairness, efficiency and neutrality of Subchapter S or even the ALI imputation credit system would be lost, except to the extent the D.R.I.P. allocation technique salvaged something. The result would be the inequities, non-neutrals and inefficiencies of a more schedular income tax system.

IV. HOW TO RETAIN SUBCHAPTER S IN AN OTHERWISE INTEGRATED WORLD

If CBIT, or any similar integration system that disallowed interest on corporate debt as a deduction were to be enacted, how could Subchapter S be preserved? If the only interest that was made nondeductible was interest paid to corporate shareholders or other business owners, if that interest was excludable to them on receipt and if that rule were not applicable to S corporations, Subchapter S elections might be undertaken in order to shift the benefit of the interest deduction to higher-bracket shareholders on the pass through of corporate profit determined after deducting interest at the corporate level. If the new rule did apply even to S corporations, it would shift income the other way, perhaps toward the lenders, as other shareholders would no longer share in the interest expense tax benefit.

Some game playing would ensue either way. But that does not add up to a recommendation against retaining Subchapter S in a CBIT world, in my view. Even in the non-electing or CBIT corporations, or all corporations if Subchapter S were revoked, some planning or schemes would be concocted to stream excludable dividends and interest to high-bracket owners and other income to
low-bracket owners, especially in closely-held businesses susceptible to such efforts. Again, unfavorable rate relationships and changes would direct and redirect these efforts in a CBIT world.

Probably for reasons such as this, Treasury proposed to exclude the smallest businesses, defined in terms of gross receipts, from the new CBIT regime.\textsuperscript{40} Since Subchapter S evidently was not to be retained, did Treasury contemplate that corporations would remain taxable under the classical system, the better advised among them managing to "zero-out" and pay no corporate income tax? If so, would not preservation of an S election be better public policy?

Subchapter S and its basis rules are designed to operate in a tax environment that includes an income tax on the capital gain if shares are sold or redeemed. If Subchapter S were retained in a CBIT world where the capital gain tax on the sale of shares was abolished, the treatment of gain or loss on Subchapter S shares would have to be differentiated (or reevaluated). How to deal with a corporation that had elected in and out of Subchapter S and CBIT seems a formidable problem. It resembles the problem presented by a small corporation excluded from CBIT that then grew and became subject to CBIT, or the reverse, a former CBIT corporation that began to fail or shrink and became eligible for the gross receipts CBIT exemption.

V. IMPLICATIONS FOR CHOOSING AMONG OTHER INTEGRATION PROPOSALS

The theoretical advantages and merits of the Subchapter S method of "integrating" the corporate and individual income taxes, or of "taxing corporate income once," and the desirability of retaining it at least as an option for domestic, one class-of-stock, closely-held corporations as at present, has even broader implications. It suggests the desirability of choosing the ALI shareholder imputation credit method, rather than either of Treasury's dividend exclusion (or CBIT) proposals as the general method of integration for corporations ineligible to make a Subchapter S election. A combination of Subchapter S for eligible, electing corporations and the ALI system for all other corporations is more sensible, coherent and feasible than a combination of Subchapter S and either of Treasury's preferred prototypes.

Subchapter S and the ALI proposal are more compatible than the other combinations. Like Subchapter S, the ALI proposal ultimately would tax distributed corporate earnings at individual shareholder rates and like Subchapter S, the ALI proposal also would do that for undistributed earnings if the corporation voluntarily allocated them to shareholders, the Carter Commission proposal would. Unlike Subchapter S, the ALI proposal would not "correctly" tax undistributed and unallocated earnings and would not integrate losses. Nevertheless, when the undistributed earnings finally were distributed (or

\textsuperscript{40} Treasury Report, note 3, at 42.
allocated) or were realized by sale of shares, or when losses became terminal and were taken into account by shareholders as share losses (either capital or ordinary by virtue of §1244), the end result would be to treat these gains and losses as sensitive to individual shareholder rates and tax return characteristics, as in Subchapter S. Treasury’s dividend exclusion and CBIT models would not do that, and hence distributed corporate earnings would be taxed very differently depending on whether a corporation were governed by Subchapter S or by a dividend exclusion/CBIT system.

The preferable policy choice, in other words, is to combine a retained Subchapter S, optional or mandatory for closely held corporations, and to enact shareholder imputation credit integration exactly as the ALI Reporter’s Study has proposed it, until ways can be found to apply Subchapter S-type integration to all corporations.

A further question is whether it actually would be harmful or costly to retain the Subchapter S election in a Treasury dividend exclusion or ALI imputation credit world. Merely to say some taxpayers would prefer to be able to make the Subchapter S election is not the same as proving that the election therefore should be retained. It is hard for me to see any real disadvantage or cost, other than some revenue losses if entity-level losses passed through, or if retained profits were taxed at once at individual shareholder rates lower than the temporary corporate rate under the ALI proposal or the final corporate rate under Treasury. The revenue loss due to lower rates on retained profits might or might not exceed the loss that would result from corporations making the D.R.I.P. election (under the Treasury prototype) or the constructive dividend/reinvestment election (under the ALI proposal).

Apart from revenue losses, what problems might result from retaining the S election on more or less the same terms as it exists now? Envy? Some opting back and forth between Subchapter S status and the integrated C world, at least if altered rate relationships or variations in rates and rate relationships such moves advantageous? Compliance and administrative costs?

One question is whether the shareholders of S-integrated corporations would be more demanding of dividends and liquid distributions to pay their tax bills on corporate profits taxable to them than would shareholders of integrated firms under the ALI or Treasury models. If this seems predictable, corporate managers, particularly of corporations in which ownership and management are separated, will not support proposals for integration along Subchapter S lines. But under either ALI or Treasury integration, the corporate tax is preserved, unlike in Subchapter S. Therefore, the integrated corporation will have to pay, say, 31% of its profits in tax under the ALI or Treasury models. In comparison, Subchapter S shareholders would be asking for no more than a comparable 31% in distributions to them if all they want is enough cash to pay their individual income taxes. So, the retention/distribution dynamics would not seem to be worse for managers and for retention/investment policies under Subchapter S than under the ALI and Treasury proposals, unless individual rates rose much above the corporate rate.

Another reason to retain Subchapter S in an integrated world is that the
income of closely-held businesses is often a combination of income from capital and income from entrepreneurial efforts or services. Under Subchapter S integration, the income preserves its character and is taxed to the individual shareholder in whatever way and rate the tax law deems appropriate. In contrast, in some integration prototypes, particularly Treasury's dividend exclusion and CBIT proposals, corporate income is taxed at a rate that may differ from that applying to other income of an individual. Whatever one may think of moving more toward a schedular income tax system and differentiating tax rates between capital income and labor income, the characterization of all corporate income as income from capital is much more palatable when applied to portfolio income of a shareholder in a widely-held corporation than to the profits of a closely-held corporation. In the latter case, preserving the Subchapter S election would allow such shareholders, who often are involved in the creation and management of the enterprise, to have not only their salaries, but also their entrepreneurial profits, taxed at the rates appropriate to them, not at a (possibly different) rate set for all capital income.

Preserving Subchapter S as an elective regime may, of course, allow a closely-held corporation to elect out of pass through treatment if doing so would be advantageous. Consequently, if a very much lower single rate were to be set for the taxation of the corporation under CBIT or the dividend exclusion prototype, thought might be given to making Subchapter S the mandatory form of integration for closely-held corporations. If that were done and if the CBIT or the dividend exclusion corporate rate subsequently were to rise much higher than the applicable, graduated rates for other income of individuals, there might be a call to separate the part of a closely-held corporation's income that truly was income attributable to capital from the part that was entrepreneurial or from services and that should be eligible for normal, individual income tax rules.

The ALI, Carter Commission or Treasury shareholder imputation-credit method of integration would not present such serious problems derived from different rates for capital and for labor income, because corporate income ultimately would be taxed at individual shareholder rates. However, until such rates become applicable, upon an actual or constructive distribution, similar considerations apply and suggest the value of retaining Subchapter S, as an elective or mandatory integration technique, for closely-held corporations. All in all, in a world of graduated rates for individual taxpayers, a different, single, flat rate final tax for small businesses seems very unattractive and unwise.

Could retention of Subchapter S as an election in a world with ALI or Treasury for more widely-held corporations do any other harm? Not more than it does in today's world of classical non-integration, it would seem.

---

41 See Gammie, note 3, at 251, 256.

42 Problems include revenue loss, elections in and out, compliance, planning and administrative costs and some influences in behavior to conform and qualify for the election.
If these are the only costs and disadvantages, and if they seem as small as they do now, they would, in my estimation, be more than offset by the gains achieved by the superiority of the Subchapter S system over the new integrated C regimes. And retaining Subchapter S would preserve the possibility of enlarging or improving it, finding solutions for its limitations and expanding it.

VI. The Prospects for Subchapter S

For years the thought has been that problems created by allowing foreign shareholders, corporate shareholders, tax-exempt shareholders and varieties of preferred shareholders in an S corporation, and ownership by an S corporation of stock in other corporations, made Subchapter S type integration impossible for all but corporations without these attributes. The difficulties created by tax-exempt and foreign shareholders are very serious. Maybe they are conclusive, but I do not want to give up yet. I want to retain Subchapter S as something that might be expanded to include larger and more varied corporate structures.

As to the corporate shareholders, and ownership of subsidiaries, and the chain ownership or circular problems of simultaneously determining income or loss to be passed through that were thought to be so serious, there are methods of accounting and mathematical methods of solving simultaneous equations that can handle those problems. At the least, Subchapter S should be broadened to allow an S corporation to have a C corporation subsidiary, even if they were barred from filing a consolidated income tax return.\textsuperscript{44} And probably a C corporation should be allowed as a "permitted shareholder" in an S corporation. To do so may amount to relaxing the limit on the number of shareholders, but not in any way that would seem to lead to serious problems or costs.\textsuperscript{45} In fact, the number limit perhaps should be abolished outright, which would produce excellent, elective integration in lots of corporations. Allowing a C corporation to own stock in an S corporation, either in small, portfolio amounts, or in larger or controlling investments, also would undermine the one class of stock requirement, but again might be a desirable and "innocent" broadening.\textsuperscript{46} Subchapter S has employed a workable system for allocating income to

\textsuperscript{44} James S. Eustice, Interview, 11 A.B.A. Section of Taxation Newsletter No. 2, 38, 40 (1992).

\textsuperscript{45} Id.

\textsuperscript{46} Id.
shareholders even when shares change hands during the year.

As to the varieties of forms of equity ownership, which are solved in the Subchapter S world by the single class of stock rule, these things, too, possibly can be solved by some accounting techniques; I am going to give those techniques a closer look. Treasury has contemplated a system in which private agreements would have to be made as to the allocation of retained earnings.47

VII. CONCLUSION

Perhaps because of his attachment to Subchapter S, Professor Ginsburg was incredulous and could not imagine that Treasury really meant to obliterate Subchapter S,48 but the Treasury Report has to mean obliteration for Subchapter S. Subchapter S is incompatible with CBIT (except if Subchapter S occupied the small business exemption from CBIT). Therefore, I believe CBIT should not be adopted.

Why not retain Subchapter S in a dividend relief world? Understand that Treasury probably has to say "because then you do not tax all business income equally," and given its goal and its tolerance of, or enthusiasm for, a flat schedular tax on this one kind of income, the response seems natural. But in any other world, or without that as a dominating criterion, it seems to me that I cannot think of any (or many) reasons not to retain Subchapter S as an elective regime for corporations eligible to choose it and perhaps gradually to expand the number of shareholders and the kinds of shareholders allowed in eligible, electing corporations.

In summary, the Treasury proposals do not so much seek to integrate the personal and corporate taxes as they do to impose a flat rate of final tax, once, and only once, on capital income that takes the form of corporate profits.49 They downplay horizontal and vertical equity, and emphasize simplicity and ease of administration, and neutrality as to sources or forms of finance. Genuine integration strives for more than just this but, as a consequence, it may be harder to achieve.

I believe the goal should be complete integration, not just dividend relief. I think we the question should be turned around: What is the role that best can be played by the ALI or Treasury models of integration in a world with Subchapter S? Presumably the best answer is to provide some integration for larger or more complicated corporations, but only for them, unless and until we can find ways to extend Subchapter S can be extended to them too. For that purpose, the ALI


49 See Gammie, note 3, at 250.
shareholder imputation credit proposal beats the two prototypes favored by Treasury.

So, I would urge that Subchapter S be retained in its present scope even in a world with ALI or Treasury integration, and that the S election be expanded to the extent possible. We should try to solve its problems and continue to hope to make it the long-term ultimate goal, perhaps a model for mandatory integration. We ought to work toward this goal even if dividend relief, in some form, ought to come in as an interim experiment — if we are reluctant now to expand Subchapter S to the entire world of corporations.
Judicial Review can be described as the power of courts to review decisions of another department or level of government. Usually a distinction is made between reviewing legislative materials by a constitutional court and review of acts of a level of government.

The series on Judicial Review in East and Central Europe focuses on the second distinction. In this issue authors from Romania and Czechoslovakia\(^1\) write about the Judicial Review in their countries.

The Editorial Staff hopes that the articles will inform the readers on the similarities and differences between the systems of Judicial Review used in East and Central Europe and the Western World.

---

\(^1\) This article was written shortly after the separation of Czechoslovakia into the Czech and Slovak Republic. Because of the uncertain future of the legal structures of these Republics we decided in consultation with the editor to publish this general article on the situation at the moment of separation. According to the editor, this legal structure will still exist for some time until there is new national legislation for both the countries.