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Can We Clean This Up? A Brief Journey Through the United States Rules for Taxing Business Entities

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CAN WE CLEAN THIS UP? A BRIEF JOURNEY THROUGH THE UNITED STATES RULES FOR TAXING BUSINESS ENTITIES

by

*Willard B. Taylor**

ABSTRACT

This article summarizes the 80-plus year history of the US federal income tax rules for classifying business entities, concluding that they result largely from administrative and/or legislative reactions to specific problems or legislative accommodations to industry lobbying efforts and do not reflect an effort to develop a comprehensive and coherent system for taxing (or not taxing) business income. While this history does not suggest that comprehensive reform is likely, the article proposes some changes that might be considered–specifically, a single tax system for non-publicly traded businesses and rationalizing the treatment of foreign investment in the US, particularly in the case of investments in stocks, securities and real estate.

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I. INTRODUCTION

The number and complexity of differently taxed business entities is an important feature of the US federal income tax. There are corporations, of course, whose income is taxed first to the corporation and then, after that, taxed again to the shareholders if distributed as dividends.[1] There are also partnerships, which generally are not taxed unless publicly traded, but whose income or loss and activities are attributed to the partners.[2] If publicly traded, a partnership may or may not be taxed as a corporation, depending on the nature of its gross income, thus creating another differently taxed business entity.

Apart from corporations, publicly traded and non-publicly traded partnerships, the United States, like many developed countries, has special tax rules for regulated investment companies (or RICs), which are the US equivalent of "collective investment vehicles" for stocks and securities, and for real estate investment trusts (or REITs). While in some respects similar to each other, the rules for RICs and REITs are separate, both from each other and from the rules that apply to partnerships and corporations. The separate rules are not simple. In addition, there are "S corporations," which are corporations that elect to be in effect treated as non-publicly traded partnerships in respect of current income, gain, or loss, but for other purposes are generally treated as corporations; "fixed investment trusts," which are used to securitize real property mortgages and to hold mineral royalties, fixed

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1. The current rate of corporate income tax is 35%, with lower rates on the first $10 million of taxable income but with the reductions phased out as taxable income exceeds $10 million; and the current personal income tax rates are 15%, 28%, 31%, 36% and 39.6%, with the applicable rate depending on the amount of the individual's taxable income and filing status, but with no more than a 20% rate on "qualified" dividend income and most long-term capital gain. I.R.C. §§ 1, 11.

2. Partnerships, as used here, would for federal income tax purposes include unincorporated entities with two or more owners, consisting principally of state law limited partnerships and limited liability companies (but also general partnerships, limited liability partnerships and business trusts not classified as fixed investment or "analogous" trusts). Reg. § 301.7701–1.

portfolios of stocks and securities, and similar investment assets, and may or may not be publicly traded; a number of entities which for federal income tax purposes are "disregarded" altogether, with the consequence that the income or loss of the entity is the income or loss of the owner (e.g., a single member limited liability company (LLC), unless it elects to be a corporation for tax purposes, a "qualified" REIT subsidiary, or a "qualified" Subchapter S subsidiary); and "real estate investment mortgage conduits" (REMICs), which were created to promote the securitization of real property mortgages in the mortgage securitization euphoria that preceded the financial crisis.[3]

Partnerships, if not publicly traded and treated as corporations, and S corporations, as well as REITs, RICs and REMICs, are "passthroughs" or conduits in the sense that the entity's income is generally taxed only once, to the owners (or, in the case of a REMIC, to the holders of regular and residual interests).[4] The mechanics of the passthrough differ, however. Partnerships and S corporations pass through credits, and each item of income, gain or loss. REITs and RICs pass through ordinary income, net capital gain, and qualified dividend income; and in the case of RICs, certain other specified items pass through, but neither RICs nor REITs pass through losses or items of income or gain not specifically identified. Partnerships may allocate items of income, gain, or loss disproportionately among their partners, but S corporations, REITs and RICs cannot.[5]

Largely because of the increasing number of partnerships and S corporations, there has been a huge growth in passthroughs in the last 30 years,[6] and this is reflected in a significant reduction in the corporate tax

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3. To take this further, a list of business entities would also include (1) "cell" or "series" companies (Prop. Reg. § 301.7701–1(a)(5), (7); Rev. Rul. 2008–8, 2008–1 C.B. 340), including series funds of a '40 Act registered company (I.R.C. § 851(g)); (2) taxable mortgage pools (I.R.C. § 7701(i)); (3) common trust funds (I.R.C. § 584); and (4) collective trust funds (*e.g*., Rev. Rul. 81–100, 1981–1 C.B. 326).

4. In targeted cases there are entity-level taxes—e.g., income from "prohibited transactions" or "foreclosure property" in the case of a REIT or a REMIC. I.R.C. § 857(b)(4), (6).

5. Dividends of a RIC or REIT generally represent proportionate shares of the passthrough income of the RIC or REIT. *See* Rev. Rul. 89–81, 1981–1 C.B. 226 (RICs); *see also* I.R.S. Notice 97–64, 1997–2 C.B. 323 (the Service's view that the ruling applies to REITs). The Consolidated Appropriations Act, 2016, Pub. L. 114-113, 129 Stat. 2242, (2016 Act) authorizes guidance on requiring proportionality in the case of REITs.

6. The growth of passthroughs, in comparison to "regular" (or C) corporations, is generally attributed to the significant changes to individual and corporate tax rates in 1986.

revenues and the corresponding increase in personal income tax revenues.[7] There are now, in number, three times or more passthroughs than there are "regular" corporations (i.e., so-called "C" corporations), and the business receipts of regular corporations are no longer more than the business receipts of S corporations, partnerships, and other passthroughs.[8] Apart from the effect on revenues, the spread of passthroughs has increased their political role and made the politics of tax reform more complicated. Regular corporations want the corporate tax rate reduced or, in the case of foreign business income, substantially eliminated. S corporations and most partnerships do not care about that, and they certainly do not want to pay for it or sacrifice their own objectives to the cost of changes in the corporate tax.[9]

How did these phenomena come about—both the number of differently taxed business entities and the growth of passthroughs? While in part the result of the evolution of state laws with respect to business organizations,[10] S corporations are entirely a creation of the tax law (although they were intended to resolve a state law issue); also creations of the tax law

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7. Personal income taxes are about 45–46% of federal receipts, payroll taxes about 33–34%, and the corporate income tax about 10–11%, with the balance accounted for by excise taxes, customs duties, the estate tax and other taxes or duties. *See* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2016 MID-SESSION REVIEW: BUDGET OF THE U.S. GOVERNMENT, Table S-4, (2016), https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/16msr.pdf. There is no US value added tax.

8. The Congressional Budget Office, for example, has reported that in 1980 passthroughs represented 83% in number and accounted for 14% of receipts; by 2007, passthroughs represented 94% in number and 38% of receipts. This is an increase of about one percent a year for 24 years. From 1980 to 2007, the percentage of businesses organized as C corporations declined from 17% to six percent in number; S corporations and LLCs grew from five percent to 20% in number; and C corporations' percentage of business receipts declined from 86% to 62%. CONG. BUDGET OFFICE, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX 8, 14 (2012). *See also* JOINT COMM. ON TAX'N., JCX-71-15, CHOICE OF BUS. ENTITY: PRESENT LAW AND DATA RELATING TO C CORPS., PARTNERSHIPS, AND S CORPS. (2015) (reporting that in 2012 there were 1.6 million C corporations, 3.4 million partnerships and 4.2 million S corporations); Michael Cooper, et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (NBER Working Paper No. w21651, 2015) (reporting that 54.2% of business income was earned by passthroughs in 2011, in contrast to 20.7% in 1980).

9. *See* Marc Heller, *Tax Law Fuels S Corporation Conversions Ahead of Overhaul*, DAILY TAX REP. (BNA), Dec. 28, 2015, at 2 ("As their numbers have grown, so has the S corporations' voice on Capitol Hill.").

10. For example, changes to state limited partnership laws that narrowed the differences between partnerships and corporations and the adoption after the check-the-box regulations of limited liability company statutes by all of the States and the District of Columbia.

are RICs, REITs, and REMICs as well as the different treatment of publicly traded and non-publicly traded partnerships. Nor is classification under state law necessarily central to how a business entity is taxed. Consider, for example, that in the beginning REITs were, as the name implies, often created as trusts, but today a REIT may as a state law matter be a corporation, a partnership, or a trust with the same tax consequences. An S corporation may be incorporated or may be organized under state law as a partnership or limited liability company and then elect for tax purposes, under the "check-the-box" regulations, to be a corporation and to be an S corporation.[11] State law classification in many cases makes no federal tax difference.

II. WHY ARE THE ENTITY CLASSIFICATION RULES IMPORTANT?

There are a number of reasons why the federal income tax rules for classifying business entities are important. First, the historical narrative of how the rules developed, far more than abstract discussions of tax policy, informs the issue of what may happen in the future—or, put differently, the likelihood and direction of any change. Second, the spread of passthroughs has significantly reduced corporate income tax revenues and, separately, distorts what is left of the corporate tax base by including most publicly traded entities but not others, such as REITs (even though they do more than make passive investments in real property and real property mortgages) and some publicly traded partnerships (e.g., those that produce, transport, store and refine oil, gas and other natural resources). Collecting the tax that is due on the income of partnerships and auditing the returns on which the partnership income is reported are tasks that are also much more difficult than auditing and collecting from corporations, particularly when there are tiers of partnerships. In addition, the classification rules sometimes overlap and result in purely tax-driven choices—for example, the decision whether a non-publicly traded business should be organized as an S corporation or as a partnership or whether a private equity fund should be organized as a partnership or (under the "business development company" rules) as a RIC. The treatment of foreign investors is not coherent and, again, forces tax-driven choices, such as whether to use a partnership or a REIT to invest in US real estate. Investments by pension plans and other tax-exempt investors are also treated differently, depending on the entity used to make the investment. These are only a few of the many issues.

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11. A significant number of S corporations are formed as state law limited liability companies. *See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corps. and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 487 (2009).

III. A SHORT HISTORY

A starting point for an historical narrative would be the 1935 decision of the Supreme Court in *Morrissey v. Commissioner*, which held that a widely held trust that was engaged in the development and sale of real estate was for federal income tax purposes an "association" and thus taxable on its income because it was within the statutory definition of a corporation.[12] The holding was on the basis that an "association" included an unincorporated entity that had the characteristics usually resulting from incorporation—centralized management, continuity of life, free transferability of equity interests, and the lack of personal liability on the part of any of the owners. How such a trust would be classified for income tax purposes was not clear before *Morrissey*.[13]

A. *Regulated Investment Companies*

Morrissey would have treated many investment trusts—trusts organized to invest "pooled" monies of investors in stocks and securities—as corporations for tax purposes, and one immediate response to the decision was the enactment in 1936 of what are now the RIC rules. These rules permit a corporation that is registered under the Investment Company Act of 1940 ('40 Act) and satisfies gross asset, gross income and distribution-to-shareholders

12. *See* Morrissey v. Comm'r, 296 U.S. 344, 360 (1935). Under the Code, a corporation "includes associations, joint stock companies, and insurance companies." I.R.C. § 7701(a)(3).

13. The taxpayer in *Morrissey* presumably relied on regulations issued after *Crocker v. Malley*, 249 U.S. 223 (1919), which held that a common law trust was not an "association" for purposes of the 1913 income tax. The Court in that case did not think there were "associates" in the absence of control by the beneficiaries, and the subsequently issued regulations determined whether a trust was an association based on the degree of control exercised by the beneficiaries over the management of the trust. *See Crocker*, 249 U.S. at 233–34. But *Hecht v. Malley* then held that common law trusts were subject to 1918 excise tax, because the tax applied to any entity "created or organized in the United States." Hecht v. Malley, 265 U.S. 144, 152 (1924). The Court said the tax applied to "organizations exercising the privilege of doing business as associations at the common law" and went on to hold that that the trusts were associations, distinguishing *Crocker* on the basis of the scope of the trusts' operations and saying that an exemption "merely because such a slight measure of control may be vested in the beneficiaries" was not justified. *Hecht*, 265 U.S. at 161. After *Hecht*, the regulations were amended to focus on whether the trust carried on a business enterprise, not whether the beneficiaries exercised control. *See* Reg. § 301.7701–4(b). The trust in *Morrissey* was organized in 1921, and presumably relied on the regulations issued after *Crocker v. Malley*, but the taxable years involved were 1924 through 1926. *Morrissey*, 296 U.S. at 346–47.

requirements[14] to elect to be a RIC, which in turn allows the corporation to deduct dividends paid to shareholders in determining its taxable income and to pass through to shareholders net long-term capital gain and certain other items of differently taxed income.[15] The concept was to provide parity of treatment for direct investment in stocks and securities and investments of "pooled" monies.

Another response to *Morrissey* and cases that followed it was the 1936 enactment of separate rules for "common trust funds." These are, broadly, funds of separate trusts contributed by a bank in a fiduciary capacity to a trust that is maintained by the bank. Some are treated as RICs, although not registered under the '40 Act,[16] but others are for tax purposes not treated as corporations and, much as in the case of a partnership (but without a number of the partnership rules, including those intended to prevent the shifting of gains and losses), a participant in such a fund takes into account the participant's "proportionate share" of the fund's income or loss.[17]

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14. The tests, broadly, are that at least 90% of the corporation's gross income consist of interest, dividends and other items of income or gain from stocks and securities, that its ownership of securities (other than government securities) is diversified, and that it distributes each year at least 90% of its ordinary income, *i.e.*, its investment company taxable income. *See* I.R.C. § 851(b). In practice RICs distribute all ordinary income and capital gain.

15. Subject to limitations, the dividends received deduction allowed to corporations, tax-exempt *interest* and foreign tax credits. "Qualified" dividend income may also pass through. I.R.C. §§ 852(b), 853, 854. Additionally, in the case of a foreign shareholder of a RIC, the RIC may pass through interest-related and short-term capital gain dividends, thus eliminating withholding tax on those items as well as on long-term capital gain dividends. I.R.C. § 871(k).

16. RICs include common trust funds if they are not described in Code section 584(a) and are not registered under the '40 Act because they are excluded under section 3(a)(C) of the '40 Act (because, for example, they do not comply with the rules of the Comptroller of Currency). I.R.C. § 851(a)(2); *see* Investment Company Act of 1940, Pub. L. 112-90 § 3(a)(C), 54 Stat. 789.

17. Specifically, this includes the proportionate share of the short-term capital gain or loss, long-term capital gain or loss, qualified dividend income, and other ordinary income or loss of the fund. I.R.C. § 584(c). On the background to common trust funds, see *Brooklyn Trust Co. v. Comm'r*, 80 F.2d 865, 868 (2d Cir. 1936), which held that a common trust fund was an "association." *See also* S. Rep. No. 74-2156, at 20 (1936), ("[i]t appears from recent court decisions that common trust funds . . . are taxable as corporations," notwithstanding that they "serve a good social purpose."). Accordingly, they are generally exempt from registration under the Investment Company Act of 1940. Common trust funds that fall out of the definition and are not registered under the '40 Act because of section 3(a)(C) may nonetheless qualify as RICs under section 851(a)(2) of the Code. The common trust fund rules should be reevaluated in light of the check-the-box regulations. *See infra* Part III.F (discussing the check-the-box regulations).

RICs currently are hugely important, both in terms of the number of investors and assets[18] and of their share of the financial markets.[19] Apart from "traditional" RICs, since 1980 RICs have included "business development companies," which are essentially private equity funds that make loans (as well as acquire shares) in smaller companies, have a class of securities registered under the Securities Act of 1934, and elect into a simplified version of the '40 Act and to be taxed as RICs.[20]

B. Real Estate Investment Trusts

The enactment of the RIC rules was followed, albeit not until 1960, by the enactment of the rules for REITs. The legislative purpose was the same as for RICs—that is, to achieve parity of income tax treatment between a direct investment and an investment of "pooled" monies in "passive" real property leases and mortgages; or, in other words, to create "mutual funds" for real estate.[21] The REIT rules were based on the RIC rules—a corporation that elected to be a REIT and met gross income, gross asset and distributions-to-

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18. For information on RICs, see the annually published Fact Book of the Investment Company Institute. The 2015 edition reports that, at the end of 2014, '40 Act RICs managed $18.2 trillion in assets (an increase of $1.1 trillion from the prior year end) for 90.4 million US investors, representing about 24% of the financial assets of US households and 43.3% of all US households. Investment Company Institute, *2015 Investment Company Fact Book*, ICIFACTBOOK.ORG, https://www.ici.org/pdf/2015_factbook.pdf (last visited Sept. 12, 2016).

19. In 2015, '40 Act RICs owned about 31% of US corporate equities, 19% of US and foreign corporate bonds, 26% of tax-exempt obligations, 11% of US Treasury and Agency securities, and 40% of commercial paper. Inv. Company Inst., *2016 Investment Company Fact Book*, ICIFACTBOOK.ORG, http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2016_factbook.pdf (last visited Oct. 30, 2016).

20. There are also unit investment trusts that may be taxed as "grantor" trusts–i.e., treated as though the assets were owned directly by the investors in the unit investment trust. I.R.C. § 851(f).

21. The relevant House Report states repeatedly that the idea was parity between RICS and REITs (e.g., the Bill "provides substantially the same tax treatment for real estate investment trusts as present law provides for regulated investment companies" and "[y]our committee believes that the equality of tax treatment . . . is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources") and that REITs, like RICs, are intended to be passive (e.g., "This bill restricts [the] pass through of the income . . . to what is clearly passive income from real estate investments, as contrasted to income from the active operations of businesses involving real estate" and "your committee has also taken care to draw a sharp line between passive investment and the active operations of business . . . ."). H.R. Rep. No. 86-2020, at 2–4 (1960).

shareholders tests[22] could deduct dividends paid to shareholders from its taxable income and thus eliminate entity-level tax. Capital gains, but not losses or other items, are passed through to the shareholders.[23]

Investing in real estate is, of course, not the same as investing in stocks and securities, and the REIT rules have evolved significantly since their enactment in 1960. REITs were originally restricted to investing in real property mortgages and leasing real property, in each case with no participation in the mortgagor's or lessor's profits; and, in the case of leases, without providing any services to tenants other than services that were not separately charged and were provided by an "independent contractor" from which the REIT did not receive any income.[24] Over time, however, the restrictions on services have been significantly cut back so that a REIT may now directly provide "customary services" to its tenants and, through subsidiaries (so-called "taxable REIT subsidiaries"), non-customary services.

While not more than 20% by value of a REIT's gross assets may consist of stock and securities of taxable REIT subsidiaries (and, as the name implies, a taxable REIT subsidiary is subject to corporate tax),[25] there is no restriction on the activities of such subsidiary. They are used by some REITs for purposes other than providing services to tenants—for example, by timber REITs to mill timber into paper products. Because of third party debt, it is not clear how much tax is actually paid by taxable REIT subsidiaries.[26]

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22. The tests, broadly, are that (1) at least 75% of the corporation's gross income consist of rents, interest, or mortgages and other items of real estate income; (2) at least 95% of its gross income consist of the income types already listed or non-real estate investment income (such as dividends from non REITs); (3) its ownership of securities (other than government securities) be diversified, and (4) the REIT distribute each year at least 90% of its ordinary income (i.e., its real estate investment trust taxable income). I.R.C. § 856. In practice, REITs distribute all ordinary income and capital gain and sometimes make return of capital distributions.

23. "Qualified" dividend income may also be passed through. I.R.C. § 857(c)(2).

24. For this purpose, the Code defines an independent contractor as a person that does not own more than 35% of the REIT and is not owned to the extent of more than 35% by other shareholders of the REIT. I.R.C. § 856(d)(3).

25. This was originally 20%, then increased to 25%, largely for the benefit of timber REITs, and recently restored to 20% by the 2016 Act for taxable years beginning after the end of 2017. *See* I.R.C. § 856(c)(4)(B).

26. *See* Thornton Matheson, *Taxable REIT Subsidiaries: Analysis of the First Year's Returns, Tax Year 2001*, STATS. OF INCOME BULL. (Spring 2005), https://www.irs.gov/pub/irs-soi/01reit.pdf ("TRSs are highly leveraged as a group, with about 30 percent of firms showing negative equity" but "loans from stockholders constitute less than 4 percent of total TRS debt . . . ."); *see also* Thornton Matheson, *The Development of Taxable REIT Subsidiaries, 2001-2004*, STATS. OF INCOME BULL. (Spring, 2008), https://www.irs.gov/pub/irs-soi/01-04coreitbul.pdf.

Additionally, the Service's interpretations of what is "real property" and "rents from real property" have evolved, and real property now includes cellular towers, data storage facilities, tunnels, bridges, billboards and other "inherently permanent" structures, while rents from real property include payments for services "customarily" provided to the users of those properties (although the payments for the services are a multiple of the payment for the physical space).[27] As a consequence, REITs now include companies that own and operate these assets, as well as private prisons, timber companies, gaming facilities, restaurants, and conference resorts.[28]

REITs today are overwhelmingly "equity" REITs. Mortgage REITs are much less important than in 1960. Although not comparable to RICs, the market capitalization of publicly traded REITs is significant.[29]

There are also many private REITs, often created by foreign persons to invest in US real estate and take advantage of the exception to US tax for gain from the sale by a foreign person of shares of a "domestically-controlled" REIT as well as other tax advantages not available without a REIT.[30] As

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The report on the 2001 returns analyzed 404 taxable REIT subsidiaries, concluding that total deductions exceeded total income and that only 42 had positive net income. While difficult to parse, the report says that (1) a number of the initial taxable REIT subsidiaries were existing corporations that converted (250 out of 480), (2) a steady growth in numbers (to 704 for 2004) and size (from assets of $16.8 billion to $68.2 billion), (3) taxable REIT subsidiaries are highly leveraged, often because of third party debt, and sometimes have negative debt-to-equity ratios (presumably based on adjusted basis, however) and, in 2001–2003, had in the aggregate negative net income, although this changed in 2004, and (4) many pay little or no tax (although in the aggregate they are taxpayers).

27. The 2016 Act also provides that personal property will be treated as real estate, if payments for the use of the property are treated as rent because of the customarily furnished rule. Consolidated Appropriations Act, 2016, Pub. L. 114-113, §102, 129 Stat. 2242, 3095.

28. The growth of REITs is also attributed to so-called UpREIT and DownREIT structures, which enable the owners of real estate to transfer the properties to a partnership below the REIT on a basis that defers any tax until they exchange the partnership interests received for the property for cash or shares of the REIT. The UpREIT structure provided the model for the Up-C structures. *See infra* notes 58–64 and accompanying text (discussing these structures).

29. For information on REITs, see REITWatch (https://www.reit.com/data-research/data/reitwatch), a monthly publication of the National Association of Real Estate Investment Trusts. There are today more than 200 publicly traded REITs with a total equity market capitalization of over $1.1 trillion, of which equity REITs account for more than $1 trillion and mortgage REITs the balance. *See* Nat'l. Ass'n. of Real Estate Inv. Trusts, *NAREIT REITWatch*, REIT.COM (Aug. 2016), https://www.reit.com/sites/default/files/reitwatch/RW1608.pdf.

30. For example, a foreign government that invested directly in US real estate would ordinarily be taxed on income and on gain from a sale, but an investment

discussed below, changes made by the Consolidated Appropriations Act, 2016 (the 2016 Act) will likely increase this use of REITs. Although a REIT must have 100 or more owners and may not be "closely held," these restrictions are not, as a practical matter, meaningful constraints on the use of private REITs.[31]

Apart from the evolution of the REIT rules, the growth of REITs results in part from a migration of regular corporations into REITs. A significant number of REITs have resulted from transactions in which a regular corporation either converted to a REIT or, on a tax-free basis, spun out real property assets into a subsidiary that converted into a REIT, which in some cases then leased back the assets to the corporation from which the REIT was spun off.[32] Conversions include most of the timber REITs and the REITs that own and operate cellular towers and data centers. The 2016 Act will slow this growth by requiring the recognition of gain on a spin-off if either the distributing or the distributed corporation, but not both, is a REIT,[33] and also

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through a REIT would eliminate any entity-level tax, and dividends, interest, and gains from sales of stocks and securities of the REIT would be exempt from tax under § 892 unless the REIT was a "controlled entity." I.R.C. § 892(a)(2).

31. One hundred or more shareholders owning a class of preferred stock that represents less than one-half of one percent of the REIT's equity is viewed as satisfying the first requirement; and "closely-held" looks only at whether more than fifty percent in value of the REIT's shares is owned by five or fewer individuals, tax-exempt benefit plans or charitable remainder trusts. I.R.C. §§ 542(a)(2), 856(a)(5)–(6), (h).

32. Penn National Gaming, Inc., Windstream Corp., and Darden Restaurants are conducting spin-offs. *See*, *e.g.*, Beth Jinks, *Penn Nat'l Sees REIT Acquiring Rivals' Casino Properties*, BLOOMBERG (Dec. 19, 2012), http://www.bloomberg.com/news/articles/2012-12-19/penn-national-sees-reit-acquiring-rivals-casino-properties; Cecile Daurat & Caitlin McCabe, *Windstream to Spin Off Networks into Publicly Traded REIT*, BLOOMBERG TECH. (July 29, 2014), https://www.bloomberg.com/news/articles/2014-07-29/windstream-to-spin-off-telecom-assets-into-publicly-traded-reit; Craig Giammona, *Darden Restaurants to Break Off Its Real Estate in REIT Deal*, BLOOMBERG (June 23, 2015), http://www.bloomberg.com/news/articles/2015-06-23/darden-restaurants-will-break-off-its-real-estate-in-reit-deal. Caesar's Entertainment Corp. has announced a spin-off to be followed by a leaseback. *See* Brian Louis, *U.S. Companies' REIT Love Affairs Seen Breaking Investor Hearts*, BLOOMBERG (Jan. 16, 2015), http://www.bloomberg.com/news/articles/2015-01-16/u-s-companies-reit-love-affairs-seen-breaking-investor-hearts.

33. This is effective for transactions after December 7, 2015, but with a grandfather clause for those transactions that had a ruling request pending with the Service—apparently an exception intended to cover the planned spin-offs of Hilton Worldwide Holdings, Caesar's Entertainment Corporation and Energy Future Holdings. *See* Eric Lipton & Liz Moyer, *Hospitality and Gambling Interests Delay Closing of Billion-Dollar Tax Loophole* N.Y. TIMES (Dec. 20, 2015),

by providing that a corporation that was a distributed or distributing corporation in a tax free spin-off is not eligible to elect to be a REIT for the ten years following the spin-off. Wholly apart from the Act, it was becoming increasingly unclear whether the Service would continue to agree that a spin-off in which either the distributing or the distributed corporation became a REIT would be tax-free, particularly if the property of the REIT was leased back.[34] Changes in the accounting rules for leases have also undercut the value of lease-backs.

Transactions in which a regular corporation becomes a REIT or spins out a subsidiary that becomes a REIT involve tax costs, but at least before the 2016 Act, the price was generally viewed as acceptable—the REIT must distribute to shareholders as dividends any earnings and profits from periods prior to the conversion, and any net gain built into the properties of the REIT at the time of conversion will be taxed to the REIT if recognized in a specified period following the conversion.[35] The requirement that the REIT distribute earnings and profits is ordinarily satisfied by a taxable distribution of additional shares, with a limited option for shareholders to elect cash in lieu of the additional shares, thus reducing the cost of the distribution to the REIT.

There is disagreement on how much tax revenue is lost through spin-outs and conversions,[36] about whether permitting conversions and tax-free

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http://www.nytimes.com/2015/12/21/us/politics/hospitality-and-gambling-interests-delay-closing-of-dollar1-billion-tax-loophole.html?_r=0. There is also an exception when a REIT spins off a taxable REIT subsidiary. I.R.C. § 355(h). At least one transactions designed to separate a corporation's real estate from its other assets has been announced since then—Bob Evans Farms Inc.'s taxable sale and leaseback of some 200 restaurants. *See* Leslie Patton, *Bob Evans Rises After Announcing Plans for Real Estate Deal*, BLOOMBERG (June 11, 2015), http://www.bloomberg.com/news/articles/2015-06-11/bob-evans-to-pursue-sale-leaseback-or-reit-for-its-restaurants. MGM Resorts is considering the transfer of seven resorts to a partnership below a REIT that will go public—*i.e.*, an UpREIT structure. *See* Andrew Blackman, *MGM Resorts to Create REIT to Be Named MGM Growth Properties*, BLOOMBERG (Oct. 29, 2015) http://www.bloomberg.com/news/articles/2015-10-29/mgm-resorts-to-create-reit-to-be-named-mgm-growth-properties.

34. *See* Rev. Proc. 2015–43, 2015–40 I.R.B. 467.

35. Originally ten years, the gain recognition period was reduced to seven and is now at five years. *See* I.R.C. § 1374(d)(7); *see also* Reg. § 1.337(d)–7(b); American Taxpayer Relief Act of 2012, Pub L. 112-240, § 326, 126 Stat. 2313, 2334.

36. While REITs are generally not subject to corporate tax because of the dividends paid deduction (and the conversion of a C corporation to a REIT thus reduces the corporate income tax), the tax on shareholders is increased because REITs, unlike regular corporations, generally distribute all ordinary income and capital gain. *See, e.g.*, Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. 1 (2015); Martin A Sullivan, *The Revenue Costs of Nontraditional REITs*, 2014 TAX NOTES TODAY 173-1 (Sept. 8, 2014); Martin A. Sullivan, *The Economic Inefficiency*

spin-outs is the right tax policy, and also whether the evolution of the REIT rules has gone too far in its definitions of real property and rents from real property.[37]

C. S Corporations

What else happened? For a business not eligible to be a REIT or a RIC, a proprietorship or partnership was the best tax choice since either would eliminate the entity-level corporate tax. But in the 1950s, neither would limit the personal liability of the owners for the obligations of the business. There were no limited liability companies; limited partnerships required a general partner and in any event did not necessarily eliminate the personal liability of a limited partner who participated in management. This forced a choice between incorporation, and the resulting entity-level corporate tax, and non-incorporation, but personal liability of some or all of the owners for the obligations of the business. To put this in context, the highest individual tax rate in 1958 was 91% and the highest corporate rate was 52%. To resolve this ostensible dilemma, and "take tax off the table" as a consideration, the S corporation rules were enacted in 1958.[38]

Broadly, the S corporation rules allow a US corporation that is owned by a limited number of individuals who are US residents or citizens to elect to treat the current income, gain or loss of the corporation in the same way as the current income or loss of partnership—that is, to pass the income, gain or loss

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of REIT Conversions, 2014 TAX NOTES TODAY 178-2 (September 15, 2014). The provision in the 2016 Act that targeted spin-offs was estimated to raise $4.3 billion in revenue over ten years, but this was reduced to $1.9 billion when a "grandfather" clause to the effective date was inserted for certain pending transactions. The final legislation also omitted the provision that would have restricted leasebacks by excluding under certain circumstances rent and mortgage interest from income that would meet the REIT gross income test. *See* Eric Lipton & Liz Moyer, *Hospitality and Gambling Interests Delay Closing of Billion-Dollar Tax Loophole*, N.Y. TIMES (Dec. 20, 2015), http://www.nytimes.com/2015/12/21/us/politics/hospitality-and-gambling-interests-delay-closing-of-dollar1-billion-tax-loophole.html?_r=1.

37. For the view that it has, consider the provisions in the Tax Reform Act of 2014, discussed *infra* at Part V; and for the view that it has not (and indeed that REITs should be expanded), see generally David Levy, Nick Gianou & Kevin Jones, *Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles*, 94 TAXES, Mar. 2016, at 381.

38. Some disagreed, arguing the limited partnerships and nonrecourse debt would take care of the problem. *See* Robert Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1146, 1175 (1958).

through to the shareholders with the same character as if realized directly by the shareholders.[39] Because it is a corporation for state law purposes, the owners are not as such liable for the obligations of the entity.

But apart from the treatment of current income, gain or loss, S corporations are corporations for tax purposes and thus the tax rules differ significantly from those that apply to partnerships. For example, an S corporation (and thus its shareholders) recognizes gain on the distribution of appreciated property to shareholders but a partnership ordinarily does not; third-party debt of a partnership may increase a partner's tax basis in the partner's interest in the partnership, and thus the partner's ability to deduct partnership losses and receive cash distributions from the partnership without tax, but only debt directly loaned by a shareholder to an S corporation is taken into account in determining the shareholder's basis in its interest in the S corporation. Partnerships may allocate items of income, gain and loss differently among partners, but shareholders of an S corporation must take into account their "proportionate" shares of each item of income, gain or loss of the S corporation.

These features of partnership taxation (and, of course, the treatment of "carried interests")[40] are particularly important in the case of partnerships in real estate and financial businesses, which are the predominant users of partnerships;[41] they are also the reason why partnerships are used in purely tax-driven transactions that seek to shift credits, losses and income among partners. On the other hand, S corporations offer advantages not available to partnerships, such as the ability to convert a C corporation to an S corporation without immediate tax, the ability of a bank to qualify as an S corporation or a "qualified" S corporation subsidiary, the ability of an S corporation to have an employee stock ownership plan (ESOP) as a shareholder and avoid current taxation of the ESOP's share of its income, the absence of entity-level audits

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39. Certain tax-exempt entities and trusts and estates may also be shareholders, and there are other qualification requirements—for example, banks that use the reserve method of accounting for bad debts and insurance companies are ineligible to be S corporations. I.R.C. § 1361(b).

40. That is, partnership interests in income and gain issued as compensation and which, if satisfying Rev. Proc. 93–27, defer the partner's tax until income or gain is realized by the partnership and allocated to the partner, and, if the gain is capital gain, in effect convert the compensation into capital gain. *See* N.Y. State Bar Ass'n. Tax Sec., *Proposed Regulations on Disguised Payment for Services*, Rep. 1330, NYSBA.ORG (Nov. 13, 2015), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2015/Tax_Section_Report_1330.html (relating to regulations under section 707 and modifications to Rev. Proc. 93–27.)

41. Real estate and finance are the principal business segments organized as partnerships, as opposed to S or C corporations, and represent 77.7% of the total assets of partnerships. *See* JOINT COMM. ON TAX'N, *supra* note 8.

by the Service,[42] and the perception that S corporations may reduce the payroll taxes that would otherwise be due if the businesses was organized as a partnership.[43] Whatever the reasons, S corporations are more popular than partnerships,[44] although partnerships may account for a larger share of business receipts.[45]

Why were the S corporation rules written in a way that created these differences? Would it not have been simpler for the S corporation rules to have provided that an electing corporation was for all tax purposes a partnership or, if there was one owner, a proprietorship? The explanation at the time was that Congress wanted the S corporation rules to be available to existing as well as new businesses, and it was concerned that simply allowing an existing corporation to elect to be a partnership would eliminate the potential corporate tax on any built-in gain in the electing entity's assets and the potential shareholder tax on any undistributed earnings and profits. As a result, Congress made the decision in 1958 to treat the S corporation as corporation except in respect of current income, gain, or loss, and thus to preserve the tax on built-in net gain and accumulated earnings. It was arguably the wrong choice (and even at the time some thought that the S corporation rules were a mistake)[46] since the concern about accumulated earnings and built-in gain

42. The TEFRA audit rules do not apply to S corporations. *See infra* 111–114, and accompanying text.

43. Because payroll tax in the case of an S corporation is limited to the wages of the shareholder. But, unless eligible for the limited partner exclusion, all of the net income of a partner in a partnership, other than certain investment income or income of a limited partner, is subject to payroll tax. *See, e.g.*, Watson v. United States, 668 F. 3d 1008, 1017–19 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

44. *See* JOINT COMM. ON TAX'N., *supra* note 8, at § 1 (reporting that in 2012 there were 3.4 million partnerships and 4.2 million S corporations).

45. The statistics with respect to business receipts do not, however, add back compensation paid to shareholders of S corporations and thus, in comparison to partnerships, understate their shares of business receipts. *See* Susan C. Nelson, *Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980-2013* (Dep't of the Treasury, Office of Tax Analysis, Working Paper No. 107, 2016).

46. *See* Anthoine, *supra* note 38, at 1175 ("At best, it is highly questionable whether the electing corporation has any proper place in a tax law that is already extremely complex. The objective of minimizing tax considerations in the selection of the form of business organization is commendable. But to say that a corporation is in some respects a corporation and in others a tenancy in common goes against the grain not only of the tax law as a whole but also of corporate law. Furthermore, there appears to be no real need for such a provision.").

could have been dealt with even if the electing corporation was treated as a partnership for tax purposes.[47]

D. Evolution of S Corporations and Partnerships

The restrictions on S corporations have been significantly relaxed since 1958. Ownership was originally limited to ten individual shareholders, all residents or citizens of the United States, but an S corporation may now have 100 shareholders (treating families as a single shareholder), and may also have tax-exempt entities (including ESOPs) as shareholders, as well as some trusts and estates. Restrictions on the amount of foreign source income and passive investment income of an S corporation have been eliminated or cut back,[48] banks may now be S corporations, and an S corporation may now also have corporate subsidiaries, including "qualified" S corporation subsidiaries (which are "disregarded entities").[49] There are also ways to work around the numerical and other limitations on the shareholders of an S corporation.[50]

Separately, the rules that apply to partnerships also evolved significantly over this period. When first codified in 1954, the rules for partnerships were short and simple—too short and simple, as it turned out, because it soon became apparent that partnerships were being used to shift taxable income, gain and loss among partners. The response over the years has been repeated statutory amendments and revisions to the regulations to close down perceived abuses, particularly in the case of the rules that apply to allocations of items of partnership income, gain and loss among partners, the

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47. The present S corporation rules deal with these issues by providing that any built-in gain in the assets of an S corporation that was formerly a C corporation (or that acquired C corporation assets in a carryover basis transaction) will be recognized and taxed to the S corporation if realized within five years after the conversion; further, the accumulated earnings and profits of such an S corporation will be taxed to the shareholders of the S corporation as dividends when distributed to the shareholders. I.R.C. § 1374. These rules could have been applied when a C corporation became a partnership.

48. An S corporation is taxable on its passive income if it has accumulated earnings and profits from a C corporation year and gross receipts of which more than 25% are passive investment income. I.R.C. § 1375. If taxation on passive income continues for three consecutive years, the S corporation election is terminated. I.R.C. § 1362(d)(3).

49. Qualified S corporation subsidiaries are disregarded entities—that is, treated as nonexistent for tax purposes.

50. *See* Rev. Rul. 94–43, 1994–2 C.B. 198 (permitting multiple S corporations to be partners in a partnership that operates a joint business in order to avoid the numerical restriction); *see also* Reg. § 1.701–2(d), Example 2 (involving a partnership between an S corporation and a nonresident alien that was established because the nonresident alien could not be a shareholder of the S corporation).

treatment of partnership debt (both recourse and nonrecourse) and the rules for contributions to (or distributions by) a partnership of property that has appreciated or depreciated. The complexity of the partnership rules is an ongoing problem, and there is plainly a need for simplification.[51]

E. Publicly Traded Partnerships

In addition to the S corporation rules, there was, after *Morrissey,* another major change in the entity classification landscape. As *Morrissey* shows, the Service, in the beginning, sought to classify unincorporated business entities as "associations" that were subject to corporate tax. Its position changed in the 1950s with the realization that professionals, such as doctors and lawyers, would prefer to have their businesses classified as "associations" since that allowed the "association" to deduct contributions to qualified pension and other benefit plans—a deduction not then available to partners in a partnership or to other self-employed individuals. Earnings of the "association" were paid out as compensation, thereby (with the deduction for contributions to benefit plans) eliminating any significant entity-level tax.

After the Service was unsuccessful in litigating association classification under the regulations existing at the time, the Treasury responded in 1960 by issuing new regulations—the so-called *Kintner* regulations,[52] which were derived from the corporate resemblance test in *Morrissey* but applied the *Morrissey* criteria in a mechanical way that made it

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51. *See* Stuart L. Rosow, *Reforming Subchapter K: The Partnership Tax Simplification Act of*______________ (Nov. 1, 2015) (manuscript), http://www.law.uchicago.edu/files/file/sub_k_draft_paper.pdf. ("[t]he history of Subchapter K for the past 40 years can be characterized as the steady development of tax avoidance schemes by taxpayers followed by regular revisions to the statute and regulations intended to combat the abuse as it is uncovered."); *see also* Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 TAX LAW. 345 (2016). With respect to complexity, see Am. Bar Ass'n. Sec. of Tax'n., *Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004*, 69 TAX LAW. 5 (2016).

52. *See* United States v. Kintner, 216 F.2d 418, 428 (9th Cir. 1954) (holding that doctors practicing as an "association" under Montana law were an association, and thus a corporation, for federal income tax purposes); *see also* H. Lawrence Fox, *The Maximum Scope of the Association Concept*, 25 TAX L. REV. 311 (1970); Marvin Lyons, *Comments on the New Regulations on Associations*, 16 TAX L. REV. 441, 444 (1961) (describing the prior regulations as beginning "by stating a definition of 'association' so broad that it offered no useful guides, and then proceed[ing] to differentiate between a trust and as an association in terms broader than those indicated in the *Morrissey* case, thus leaving the subject in a much more uncertain state that was justified by *Morrissey*.").

more difficult to be an "association" (and much easier to be a partnership). Under the new regulations, an unincorporated entity that carried on a business and had multiple owners (or "associates") would not be an association unless it had at least three of four corporate characteristics—limited liability of all of the owners, free transferability of equity interests, centralized management, and continuity of life. The characteristics were not weighted and did not include, as some suggested, a simple limit on the number of limited partners that a partnership could have without being classified as an "association." At the same time, there had been a significant growth in the use of limited partnerships, and state laws had narrowed the differences between corporations and partnerships, ultimately accommodating public trading in limited partnership interests.[53]

As business soon realized, the new regulations and the evolution of limited partnerships meant that a publicly traded business could be a partnership for tax purposes and avoid corporate tax. For example, a limited partnership in which a corporate general partner had a relatively small interest (and which amounted to the general partner's principal asset) would be a partnership, notwithstanding that its limited partnership interests were publicly traded, since it did not have limited liability or have continuity of life (if the insolvency of the general partner would terminate the partnership). A number of businesses converted to, or were organized as, publicly traded limited partnerships. Congress responded to the threat to the corporate tax base by enacting rules in 1987 providing that a publicly traded, unincorporated entity, whether a partnership, trust, or other entity, would be treated as a corporation for tax purposes unless 90% or more of its gross income for each year in which it was publicly traded consisted, broadly, of income from commodities, real estate, investments in stocks and securities or the exploration, production, transportation, and processing of natural resources.[54] The "good" gross income exception generally does not apply if the entity is registered under the Investment Company Act of 1940, with the consequence that passthrough

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53. In Rev. Rul. 88–76, the Service ruled that a Wyoming limited liability company was a partnership because in the particular circumstances it lacked the corporate characteristics of continuity of life and free transferability of interests. Rev. Rule. 88–76, 1988–2 C.B. 360, *obsoleted by*, Rev. Rul. 98–37, 1998–2 C.B. 133. The ruling abandoned a position that would have classified a limited liability company as an association in the absence of personal liability. Since 2000–2001 the number of limited liability companies has grown much more than the number of general or limited partnerships. *See* JOINT COMM. ON TAX'N., *supra* note 8; *see also* Chrisman, *supra* note 11.

54. I.R.C. § 7704(c)–(d). In 1986 Congress also repealed what was left of the *General Utilities* doctrine thus eliminating the possibility that an existing corporation could without significant tax become a partnership.

treatment for a '40 Act registered entity is generally available only under the RIC rules.[55]

Because of the "good" income exception to the 1987 legislation, however, publicly traded partnerships are significant, particularly those that derive income from natural resources.[56] Most are organized as limited partnerships, although some are limited liability companies. The natural resource partnerships are mostly in "midstream" activities, such as gathering and processing, compression, transportation and storage, and marketing. Most were formed after the 1987 legislation. Energy (including non-traditional energy) publicly traded partnerships are about 83% of the industry's market capitalization. More recent arrivals include publicly traded partnerships in the investing and asset management business, which are not '40 Act registered, such as Carlyle, KKR, Fortress and Blackstone. There are also publicly traded partnerships that invest in commodities and commodity derivatives, real estate and real estate mortgages. The number of partnerships with at least 100 partners and $100 million in assets has tripled since 2002 to over 10,000, while the number of new C corporations decreased in the same period by 22%.[57]

Related to the growth of publicly traded partnerships are so-called "Up-C" structures in which a partnership is not publicly traded but is, in part, owned by a publicly traded corporation, thus giving the business access to capital market investors and, in some cases, providing liquidity to the partners by giving them the opportunity to exchange their partnership interests for shares of the publicly traded corporation.[58] The model for the structure is the

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55. There is an exception in section 7704(c)(3) for a partnership that is registered under the '40 Act but whose principal activity is buying or selling commodities (other than as a dealer) or options, futures, or forwards with respect to commodities. I.R.C. §7704(c)(3). Such a partnership could likely not qualify as a RIC.

56. *See* Wells Fargo Securities, *MLP Primer Fifth Edition: A Guide to Everything MLP*, MLPASSOCIATION.ORG, 19, 31, 50, (Oct. 31, 2013), https://mlpprotocol.files.wordpress.com/2013/03/wells-fargo-mlp-primer-5th-edition.pdf (there are now some 135 of such partnerships (and more if those traded over the counter or otherwise not on a public exchange are included), of which 107 are energy-related, with an aggregate market capitalization of more than $445 billion. The market capitalization at the end of 2010 was $230 billion.).

57. U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-732, LARGE PARTNERSHIPS WITH GROWING NUMBER OF PARTNERSHIPS, IRS NEEDS TO IMPROVE AUDIT EFFICIENCY 1 (2014). Not all of these are publicly traded.

58. The initial public offerings in 2014 by GoDaddy Inc. and Shake Shack Inc. used this structure. A number of the financial and asset management partnerships are organized this way—for example, Lazard Freres Inc., Moelis & Co., and Artisan Partners Asset Management Inc. *See* John LeClaire & Brad Weber, *The UP-C IPO: A Structure That Keeps on Giving*, BUYOUTSNEWS.COM (Feb. 9, 2015), http://www.goodwinlaw.com/~/media/7BE5CF865E864647BA2309795BC60C2F.p

UpREIT structure used when publicly traded REITs are established to acquire privately held real estate,[59] and Up-C structures are widely used by private equity investors and others to take privately-owned businesses public. It creates a hybrid, in which some of the income of the partnership business is subject to corporate tax and some is not, with the corporate tax sometimes significantly reduced when partnership interests are exchanged for shares.[60] "Inverting" (or expatriating) US businesses have also used the structure—i.e., the publicly traded corporation is incorporated outside of the United States.[61] It is not clear as a policy matter why the partnership in an Up-C structure should not be treated as publicly traded, particularly if the other partners in the partnership have the opportunity to exchange their interests for shares of the corporation.[62]

Up-C structures often involve controversial[63] tax receivable agreements which return to the partners that transfer their interests a percentage (typically, by market convention, 85%) of the tax benefits to the corporation of the step-up in the basis of the partnership's assets, including the tax benefit of any deduction allowed for interest income imputed to the partners.[64] The premise of the transactions is that the market looks at the

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df. The "C" in the Up-C structure refers to a regular corporation that is subject to the rules in Subchapter C of the Internal Revenue Code.

59. In an UpREIT, private investors in real estate transfer real estate on a tax-deferred basis to a partnership in which a REIT is the general partner, receive limited partnership interests in exchange, and have the right after a period of time to exchange the partnership interests for shares of the REIT.

60. Gain recognized by the exchanging partners will step up the basis of the partnerships assets, assuming that a section 754 election has been made, and this will reduce the taxable income of the C corporation.

61. Consider, for example, Frank's International N.V., which went public in 2013. *See* Cory Hester, *Anti-inversion Measures Jeopardize Frank's International's Tax Status*, WESTLAW CAPITAL MARKETS DAILY BRIEFING, Mar. 10, 2015, 2015 WL 1001329.

62. Reg. § 1.7704–1(c) (generally limits publicly traded to a case where there is an opportunity to exchange "in a time frame and with the regularity and continuity that is comparable to that" provided by a secondary market).

63. *See* Gregg Polsky & Adam Rosenzweig, *The Up-C Revolution* (Oct. 13, 2016) (manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2851872; Amy S. Elliot, *IPO Agreements That Shift Basis Step-Up Benefit to Sellers Are Proliferating*, 2011 TAX NOTES TODAY 140-1 (July 20, 2011); Robert Willens, *The Private Equity Version of The "Supercharged" IPO Is Nothing New*, 2007 TAX NOTES TODAY 157-35 (Aug. 13, 2007).

64. This feature of the Up-C transaction derives from transactions in which a subsidiary of a corporation is taken public and there is a section 338(h)(10) election to step up the basis of the subsidiary's assets, i.e., the public offering is treated as a purchase of the subsidiary's shares, permitting the election, and an agreement by the subsidiary to pay over to the corporation the tax savings of the step up.

subsidiary's earnings before interest, tax, depreciation, and amortization (EBITDA) and thus does not value the step up in basis.

F. The Check-the-Box Regulations

The 1987 enactment of the publicly traded partnership rules took some pressure off the corporate tax base. Faced with the mechanical regulations that had been adopted in 1960 to define an "association," the Treasury and the Service concluded that it was sensible to provide that the classification of an unincorporated entity that was not publicly traded should be elective—as a practical matter, under the 1960 regulations, it already was elective in the case of unincorporated US entities.[65] Regulations to this effect—the so-called "check-the-box regulations"—were adopted for 1997 and subsequent years. The regulations provide that an unincorporated entity with two or more owners will, at the entity's election, be a partnership or a corporation, and that an unincorporated entity with a single owner will, at the entity's election, be a corporation or a "disregarded entity," which is an entity that does not exist for tax purposes.[66] In effect, the only criterion that is now relevant to classification of an unincorporated entity is public trading (and, arguably, public trading is narrowly defined). The other criteria that *Morrissey* considered important—i.e., centralized management, continuity of life, and limited liability—no longer count.

Although intended to simplify the entity classification rules, the check-the-box regulations created new complexities, particularly in the case of cross-border transactions because the regulations increased the opportunity for mismatches and tax arbitrage resulting from the different classifications of an entity under US and foreign tax law.[67] They also significantly expanded the

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65. This was not necessarily the case for foreign entities, but they were included (with modifications) in the check-the-box regulations. Reg. §§ 301.7701–2, –3. This, of course, led to the significant use of hybrid entities to arbitrage tax systems.

66. Treas. Reg. § 301.7701–2(a).

67. Among others, the issues include: (1) the treatment of payments to and by hybrid entities for withholding tax and other purposes (I.R.C. § 894(c)); (2) the unsuccessful effort to deal with hybrid branch payments (*see* I.R.S. Notice 98–11, 1998–1 C.B. 433, *withdrawn by* Notice 98–35, 1998–2 C.B. 34 (which at one point was part of the Administration's tax proposals)); (3) the now-abandoned proposed regulations addressing certain "extraordinary transactions" (Notice 2003–46, 2003–28 I.R.B. 53 (announcing intention to withdraw Prop. Reg. § 301.7701–3(h)); (4) the concept of "indirect use" of losses in the dual consolidated loss regulations; (5) the definition of a "person" for purposes of the conduit financing regulations; (6) the special foreign tax credit rules for taxes imposed on the income of "reverse hybrids" (which have been expanded by 2010 enactment of rules relating to the separation of income and the foreign taxes on the income, *i.e.*, "splitters", and on income resulting

presence of "disregarded entities"[68] and, thus, the need for rules to address "notional" transactions resulting from reclassification (e.g., a partnership becoming a disregarded entity because of a change in ownership, or vice versa; or a partnership or disregarded entity electing to be a corporation, or vice versa).

G. *Fixed Investment Trusts and REMICs*

Morrissey did not classify as an "association" every trust that had multiple beneficiaries (or "associates") and was created for business purposes. As subsequently interpreted, if the trustees had no power to vary the investments of the trust, other than fiduciary or "protective" powers, a trust would be classified as such and not as an "association."[69] The absence of power to vary investments in effect means that the trust can only own passive or non-operating assets, such as stocks and securities, and must regularly distribute any cash from its investments.[70]

Fixed investment trusts are "grantor" trusts, with the consequence that for tax purposes the beneficiaries are treated as owning their shares of the income and assets of the trust. Classification as a fixed investment trust is much less important with the adoption of check-the-box regulations since, apart from trusts used to securitize mortgages,[71] a trust that fails to qualify—for example, because the trustee has the power to vary investments—would ordinarily be classified as a partnership because of the "good" income exception, even though it was publicly traded[72] Fixed investment trusts are still significant, however, and include publicly traded trusts that hold oil and

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from "covered" acquisitions (*see* I.R.C. § 901(m)); (7) the treatment of contributions to a disregarded entity owned by a charity; (8) whether a check-the-box election with respect to a foreign subsidiary is a sufficient event to trigger a worthless stock deduction; and (9) regulations with respect to whether partnership allocations have substantial economic effect when one of the partners is a controlled foreign corporation or other "look-through" entity (*see* Reg. § 1.704–1(b)).

68. Outside of the check-the-box regulations, S corporations and REITs may have subsidiaries that are disregarded entities.

69. *See* Comm'r v. Chase Nat. Bank, 122 F.2d 540, 543–44 (2d Cir. 1941); Comm'r v. Buckley, 128 F.2d 124, 125–26 (9th Cir. 1942) (following *Chase*, holding there was a trust, and rejecting the Service's argument that "all investment trusts should be classified as corporations. . . ."); *id.* at 126 (Haney, J., dissenting) ("I cannot agree with the technical refinements of the majority opinion in [*Chase*]").

70. *See, e.g.*, *American Participations-Trust v. Comm'r*, 14 T.C. 1457, 1466 (1950) (regarding the need to distribute and not retain proceeds).

71. A trust used to securitize mortgages that was not a fixed investment trust may be a "taxable mortgage pool" if it has two or more classes of pay-through interests, with the consequence that it will be treated as a corporation. I.R.C. § 7701(i).

72. I.R.C. § 7704(d).

gas and other mineral royalties,[73] gold bullion and other precious metals, and are used to securitize mortgages.

In 1984 the fixed investment trust regulations were modified to provide that, in addition to the absence of power to vary the trust's investments, there could only be one class of interests in the trust.[74] The concern was that multiple classes could (like coupon stripping before the enactment of section 1286) result in interest deductions by mortgagors that exceeded the income currently taxed to the holders of interests in the trust. The single class of interest rule limited the use of fixed investment trusts to securitize mortgages since, with a single class of interests, it was not possible to have different maturities and thus to shift the risks of mortgage defaults and prepayments among classes of interests in the trust. The change in the regulations and the absence of other alternatives for securitizing mortgages in a way that allowed risks to be shifted between classes of interests in a pool of mortgages led to the enactment in 1987 of the real estate mortgage investment conduit, or REMIC, rules.[75]

A REMIC, like a fixed investment trust used in mortgage securitizations, holds a fixed pool of mortgages but unlike a fixed investment trust may issue, without restriction, debt-like instruments (so-called "regular" interests) with terms that may shift risks of mortgage default and prepayment among the interests.[76] Regular interests are treated as debt for tax purposes, and any income or loss of the REMIC after deducting interest and original issue discount on the regular interests is taken into account by the holders of the "residual" interests in the REMIC. Because the interest payments currently deductible by the mortgagors may exceed the current income of the holders of the regular interests of a REMIC, the residual interest may have "phantom" income—that is, taxable income without cash flow—and a negative fair market value. There are complex rules to ensure that this income is currently

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73. Unlike Canadian royalty trusts, US royalty trusts are restricted to owning the royalty interests held at the inception of the trust and to paying out the net income, and they cannot manage properties or acquire new properties. *See* Reg. § 301.7701–4(a).

74. Reg. § 301.7701–4(c) (as amended in 1996).

75. Rules for "taxable mortgage pools" set out in section 7701(i) were also enacted but with the effective date deferred until 1997. *See* Pub. L. 104-188, §860L, 110 Stat. 1755. The taxable mortgage pool rules endeavor to make REMICs and REITs the exclusive vehicles for securitizing mortgages if the pool is the "obligor under debt obligations with 2 or more maturities," then it will be a taxable mortgage pool (unless a REMIC or REIT). I.R.C. § 7701(i).

76. A REMIC may be a trust, partnership, corporation, or any other entity; it may also be a segregated group of assets of any entity. I.R.C. § 860D; Reg. § 1.860D–1(c).

taxable—for example, rules specify that the holder of the residual interest cannot offset the income with net operating loss carryovers, that ownership of the residual interest by a tax-exempt entity will not avoid tax on the income, and that the residual interest cannot be transferred to a person not able or willing to pay the tax.[77]

IV. CAN HISTORY BE REWRITTEN? WILL IT BE?

The present entity classification rules are plainly less than perfect—no one, looking back, would write the rules as they are now written. They result in part from administrative and/or legislative reactions (such as, for example, the *Kintner* regulations and the enactment of the S corporation rules) to specific problems and from legislative accommodations to industry lobbying efforts (such as, in the case of REITs, the taxable REIT subsidiary rules and the treatment of "customary services" income as rent). Whatever the cause, the present rules certainly do not reflect any effort to develop a comprehensive and coherent system for taxing (or not taxing) business income, not does their evolution suggest that such an effort is likely.

What are the issues? There are many, but one that is certainly worth attention is the question of the ongoing role of the corporate income tax in the federal income tax system given the spread of passthroughs in the last 30 or so years and the resulting decline in corporate income tax revenues. Should it be kept, strengthened, or replaced, for example, with an "integrated" system in which dividends are deductible or shareholders are given a credit for the corporate tax?[78] Or with a Federal value added tax?[79] Is public trading the right line to draw between entities that are subject to the corporate tax and passthroughs that are not and, if it is, how should public trading be defined? Passthroughs also make the collection of tax more difficult, and, while there now are rules for auditing and collecting tax from large partnerships,[80] this is

77. I.R.C. § 860E. There are also rules for "REMIC inducement fees," i.e., payments made to a person to induce the person to acquire a residual interest. Reg. § 1.446–6.

78. There is some integration in the present system since the maximum personal income tax rate for qualified dividend income is generally 20%, i.e., the same as for net long-term capital gain. On this issue generally, see David M. Schizer, *Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both)* (Colum. L. Econ. Working Paper No. 536, 2016), http://ssrn.com/abstract=2788713

79. The United States is the only OECD country that does not impose a value-added tax.

80. The Bipartisan Budget Act of 2015 provides for partnership level audit and collection procedures in the case of partnerships, but this still leaves out many passthroughs, since partnerships with 100 or fewer partners may elect out. There are no entity-level audit rules for S corporations (other than the requirement that an S corporation shareholder must report on a basis consistent with the S corporation unless

still an issue that needs to be addressed further so long as passthroughs account for such a significant amount of business income.

Related to the declining importance of the corporate tax, of course, is the distortion that results from the absence of corporate tax on publicly traded partnerships in the natural resources and financial services businesses and on REITs that are engaged in active businesses and do not simply make investments in "passive" real property leases and mortgages. The generous interpretation of what is real property and rents from real property, together with other changes made since the enactment of the REIT rules in 1960, has resulted in a huge expansion in REITs; REITs now include, for example, companies with thousands of employees and that own and operate cellular communication towers and data processing centers.[81] The "good" gross income exception to the publicly traded partnership rules[82] gives partnerships in the natural resources sector and, more recently, also those in the financial advisory business, tax advantages that other publicly traded businesses do not have.

There are at least two other issues that might usefully be addressed. One is the extent to which choice of entity decisions have become tax-driven. Because a business might be organized under more than one set of rules, the present system often results in tax-induced choices—for example (and to re-emphasize questions posed in Part II), whether a business should be an S corporation or a partnership or whether a private equity fund should be organized as a partnership or, under the business development corporation rules, as a RIC.[83] Another example is the different treatment for investments by foreign investors. The rules are not coherent and, again, force tax-induced choices between, for example, investing directly in US real property, investing as a partner in a partnership, or investing as a shareholder of a REIT.

Wholly apart from these substantive issues, the entity classification rules have many smaller flaws, such as the ability of a RIC or publicly traded partnership to convert "bad" income into good income through the use of "blocker" subsidiaries[84] and the ability of a RIC to convert income it derives

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the shareholder notifies the Service). *See* Bipartisan Budget Act of 2015, Pub. L. 114-74, § 1101, 129 Stat. 584, 625–26.

81. Timber, data processing, and cellular communications REITs account for six of the twenty-six largest REITs by market capitalization. *See* Nat'l. Ass'n. of Real Estate Inv. Trusts, *supra* note 29.

82. I.R.C. § 7704(d).

83. There are also structures in which a business is conducted by a partnership partially owned by a publicly traded corporation, with the balance held privately.

84. *See*, *e.g.*, Emily Cauble, *Taxing Publicly traded Entities*, 6 COLUM. J. TAX L., 147, 164 n.100 (2015).

as a partner in a publicly traded partnership into dividend income. The rules also raise many questions, including whether, given the check-the-box regulations, it still makes sense to have separate statutory rules for common trust funds.[85] A complete list of flaws and questions would be very long.

Will history be rewritten?[86] The entity classification rules could certainly be changed, but as set out below significant change seems unlikely in the absence of comprehensive tax reform that would address many other issues, including the treatment of the foreign income of US corporations and the rates of individual and corporate tax. And the politics of restricting passthroughs have become more difficult given the increasing popularity of S corporations and partnerships and their emergence as a lobbying force. Tax provisions in the Budget Reconciliation Act and the 2016 Act, both enacted at the end of 2015, clearly make the case for the difficulty of comprehensive change.

V. THE TAX REFORM ACT OF 2014 AND OTHER LEGISLATIVE PROPOSALS

Two of these issues—the distortive effect of imposing corporate tax on some publicly traded entities but not others and the separate rules of S corporations and partnerships—were addressed by the Tax Reform Act of 2014 that was introduced by Representative Camp, then Chairman of the House Ways & Means Committee at the end of 2014.[87] The act was essentially put forward as a possible model for comprehensive tax reform and not with any realistic expectation that it would be enacted soon in part or in whole.

There are, in theory, a number of options for dealing with the different tax treatment of regular corporations and of passthroughs, including reducing the rate of corporate tax so it makes less difference or replacing the present corporate tax with one that allows a dividends paid deduction or a credit to shareholders. The Tax Reform Act of 2014 did not go in that direction, but rather it would have kept the present corporate income tax, albeit with a lower rate and with different rules to determine the tax base, but with restrictions on what REITs and publicly traded partnerships could do.[88]

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85. The alternative would be to classify them as partnerships.

86. Or reimagined? *See generally* Levy, *supra* note 37 (arguing that the corporate tax should never have been an issue for real estate trusts since the corporate tax was essentially about taxing retained earnings).

87. Tax Reform Act of 2014, H.R. 1, 113th Cong. §§ 3001, 3601–22 (2014).

88. The Tax Reform Act of 2014 would have reduced the rate of corporate tax from 35% to 25% over four years. *Id.* at § 3001. It also would have changed the rules for active foreign business income by establishing a "participation exemption system" under which a 95% dividends received deduction would be allowed for dividends paid by foreign subsidiaries out of active foreign business income, thus

A. Real Estate Investment Trusts

In the case of REITs, the Tax Reform Act of 2014 would have prevented regular corporations from converting, through spin-offs or otherwise, to REITs,[89] and also would have moved the rules on REIT investments back towards where they started in 1960.[90] Timber REITs (as well as timber publicly traded partnerships) would have been eliminated.[91] The basic justification for the changes to the REIT rules, (to quote the Ways & Means Committee's Section-by-Section Summary) was that "[t]he REIT rules were not intended to facilitate erosion of the corporate tax base by allowing operating companies to convert from taxable C corporations into REITs."[92]

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reducing the rate of tax on that income to 1.5% (i.e., 25% of 5%). No foreign tax credit would be allowed for foreign income taxes paid on that income. *Id*. at § 4001.

89. Specifically, the Tax Reform Act of 2014 would have denied tax-free treatment to a spin-off or split-up if either corporation was a REIT, prevented the use of taxable stock dividends to eliminate earnings and profits accumulated before the conversion, and required the immediate recognition of the built-in gain in the REIT's assets. *Id*. at §§ 3631, 3639.

90. A new definition of real property would have excluded property with a class life of less than 27.5 years, and new rules would have prevented a REIT from deriving significant income from income-based rents or interest, presumably in most cases paid by a related C corporation. *Id*. at §§ 3633, 3635. The percentage of assets that could be represented by securities of taxable REIT subsidiaries would drop back to 20%, and the use of related party deductions to reduce the income of taxable REIT subsidiaries would be further restricted. *See* Tax Reform Act of 2014, *supra* note 87, at § 3644.

91. The draft would have excluded timber from the definition of real property and repealed the special timber REIT rules. *See* Tax Reform Act of 2014, *supra* note 87, at § 3634. There are at least five publicly traded timber REITs—CatchMark Timber, Plum Creek Timber Company, Inc., Potlatch Corporation, Rayonier Inc., and, most-recently, Weyerhaeuser Company. *See* Brooks Mendell, *Joe Namath and U.S. Timberland Ownership over Time*, FORISK.COM (July 15, 2016), http://www.forisk.com/blog/2016/07/15/joe-namath-u-s-timberland-ownership-time/. All are conversions in which the non-qualifying activities (cutting, milling and manufacturing, as well as mineral extraction, real estate development and sales) were dropped into taxable REIT subsidiaries or spun-off. *See* Brad Thomas, *Timber REIT Giants Branching Out*, FORBES.COM (Nov. 9, 2015), http://www.forbes.com/sites/bradthomas/2015/11/09/timber-reit-giants-branching-out/#286443114157. Two of the 15 REITs in the S&P 500 index are timber REITs. *See* Brooks Mendell, *How Did Timber REITs Perform in 2015?*, FORISK.COM (Jan. 4, 2016), http://www.forisk.com/blog/2016/01/04/how-did-timber-reits-perform-in-2015-what-should-investors-watch-in-2016/.

92. H. WAYS AND MEANS COMM., 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT: SECTION-BY-SECTION SUMMARY 123 (2d Sess. 2014).

The 2016 ACT, which was enacted at the end of 2015, picked up on a few of the changes to the REIT rules that were proposed in the Tax Reform Act of 2014, essentially as a way of raising revenue to pay for a significant relaxation in the FIRPTA rules that apply to foreign investments in US real estate.[93] Under that legislation, a spin-off is not tax-free to the corporation or to its shareholders if either the distributing or the distributed corporation is a REIT (although a spin-off of a REIT by a REIT or of a taxable REIT subsidiary by a REIT could qualify),[94] and neither the distributing nor the distributed corporation in a tax-free spin-off will be eligible to become a REIT for ten years.[95] Additionally, the legislation also reduced the percentage of a REIT's assets that could consist of securities of taxable REIT subsidiaries from 25% to 20%, which is where it started when the taxable REIT subsidiary rules were enacted in 1999. Apart from these changes and the relaxation of the FIRPTA rules, however, the changes made by the 2016 Act to the REIT regime generally granted what the REIT industry, or specific REITs, wanted[96] and do not address basic issues such as the definitions of real property and rent from real property.

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93. Although, as noted, in the end most of the projected revenue was lost when a grandfather clause for some pending transactions was added. *See*, *e.g*., Laura Davison, *REITs–Tax Deal Trades REIT Spinoffs for Foreign Investment*, DAILY TAX REP. (BNA), 2015.

94. I.R.C. § 355(h).

95. The spin-off rule applies to transactions after December 7, 2015 but with a grandfather provision for transactions for which an I.R.S. ruling had been sought by that date. *Id*; *see* Consolidated Appropriations Act, 2016, Pub. L. 114-113, §311, 129 Stat. 2242, 3091. The grandfather provision was apparently intended to cover proposed spin-offs by, among others, Hilton Worldwide Holdings, Inc., Caesar's Entertainment Corporation and Energy Future Holdings. *See* Lipton & Moyer, *Hospitality and Gambling Interest*s, *supra* note 36. The final legislation also dropped a provision that would have limited leasebacks of spun-off assets, apparently to accommodate Penn National Gaming and others who would have been affected.

96. These include, for example, (1) liberalizing the prohibited transaction safe harbor, (2) repealing the preferential dividend rule in the case of publicly-offered REITs, (3) treating non mortgage debt issued by publicly-offered REITs as real estate assets, (4) defining real estate to include "ancillary" personal property (personal property if the payments for its use are treated as rent), (5) allowing taxable REIT subsidiaries to perform certain activities that had previously be limited to independent contractors, (6) expanding the hedging rules, and (7) reducing the gain recognition period for built-in gain of a C corporation that became a REIT (or a RIC or an S corporation) to five years. I.R.C. § 1374; Reg. § 1.337(d)–7(b). The 2016 Act also increased the FIRPTA withholding tax rate to 15% but, given the other changes to FIRPTA, it is unlikely this will affect most REITs.

B. Publicly Traded Partnerships

The Tax Reform Act of 2014 would also have dramatically changed the publicly traded partnership rules, first, by expanding the definition of public trading (and thus the number of partnerships that would have to meet the "good" income test in order not to be taxed as corporations) and, second, by cutting back on the definition of what is "good" income.[97]

Under the Act, the determination of whether a partnership is publicly traded or not would have turned on whether interests in a partnership were publicly traded within the meaning of the rules used to determine whether debt obligations are issued at a discount.[98] Because those rules focus on determining the value of the interests in the partnership, rather than on whether there are ongoing opportunities to sell, the Act would have treated many more partnerships as publicly traded, including partnerships used in Up-C structures if there was a right to exchange partnership interests.[99]

The Act would also have excluded real property income, investment income, and income from commodities from the gross income that counts as "good" income for the purposes of determining whether 90% or more of a publicly traded partnership's gross income is "passive." This would have made REITs the exclusive passthrough vehicle for publicly traded investments in real estate, much the way that RICs are the exclusive vehicle for publicly traded entities investing in stocks and securities.[100] But the changes would also have meant that financial services and asset management partnerships that have gone public in the last decade (e.g., Blackstone, Fortress, Carlyle Partners) could no longer qualify for the "good" income exception, and it

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97. *See* I.R.C. § 7704(d) (current rule regarding qualifying income).

98. *See* I.R.C. § 1273 (relating to the determination of original issue discount on debt obligations).

99. The section 1273 regulations treat instruments as publicly traded if there is a sale or if they appear on a quotation medium. Under the section 1273(b) regulations, for example, debt can be publicly traded if, at any time in a 31-day period beginning 15-days after its issuance, "[t]here are one or more indicative quotes . . ." defined as being the case "when a price quote is available from at least one broker, dealer, or pricing service . . . for the property and the price quote is not a firm quote," or if there is a sale of the instrument within that period. Reg. § 1.1273–2(f).

100. Under section 7704 the qualifying income exception does not apply to a '40 Act registered entity unless the principal activity is buying and selling commodities (but not held for sale to customers) or options, futures, or forwards with respect to commodities. I.R.C. § 7704(c)(3).

would also have meant that income from investing and trading in commodities was no longer "good" income.[101]

In the end, however, the 2016 Act left publicly traded partnerships alone and did not include any of the changes proposed in the Tax Reform Act of 2014.

C. Partnerships and S Corporations

Apart from REITs and publicly traded partnerships, the Tax Reform Act of 2014 also posed the question of whether the separate rules for non-publicly traded partnerships and S corporations made sense. A discussion draft, released by the House Ways and Means Committee in March of 2013, under the heading "Provisions To Reform the Taxation of Small Businesses and Passthrough Entities," offered the possibility of a single set of rules for partnerships and corporations that were not publicly traded.[102] In other words, the rules that applied to non-publicly traded entities would be the same without regard to incorporation (unless the entity opted to be a regular corporation). This option—so-called "Option 2"—was dropped when the Act was introduced at the end of 2014, no doubt in response to less than enthusiastic comments,[103] and the changes proposed by the Act were, in the end, relatively modest.[104]

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101. Natural resources income would still be "passive" income (I.R.C. § 7704(c), (d)(1)(E)), but the exclusion of real property income may affect publicly traded partnerships in that sector if, for example, offshore drilling rigs were owned.

102. H. WAYS & MEANS COMM., 113TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (1st Sess. 2013). Treatment as a regular C corporation would still be an option for a non-publicly traded business. *See* Reg. § 301.7701–1, *et seq*.

103. *See* Amy Elliott, *Camp's Proposed Passthrough Unification Is Not a Step Toward Corporate Integration*, 2013 TAX NOTES TODAY 65-1 (April 3, 2013).

104. In the case of partnerships, these included (1) repealing section 707(c), relating to guaranteed payments for services or the use of capital (because it has "created a great deal of uncertainty, confusion, and controversy"); (2) eliminating the elections in sections 734 and 743 so that an adjustment to the basis of partnership property to reflect a sale of a partnership interest by a partner or the distribution of property by a partnership is mandatory (not elective or dependent on the built-in loss in partnership property being "substantial" after the distribution) and also applicable to tiered partnerships; (3) eliminating the seven-year restrictions on the "mixing bowl" rules (I.R.C. §§ 704(c)(1)(B), 737(b)(1)) on the allocation of pre-contribution gain or loss of property when the contributed property is distributed to another partner or other property is distributed to the contributing partner; and (4) broadening the "hot asset" rule in section 751 so that it treats a distribution of inventory to a partner as a sale, whether or not the inventory has appreciated "substantially" and simplifying the definition of an unrealized receivable so that it includes any property to the extent of

The elimination of a possible one-track system for S corporations and partnerships that were not publicly traded, although predictable, was unfortunate. If there are changes in the partnership and S corporation rules, it would make more sense to have a single set of rules for non-publicly traded passthroughs than simply to make changes to the separate rules that apply to S corporations and partnerships.[105] The two-tracks system came about for reasons that are no longer valid. With the availability of limited liability companies, limited liability for an unincorporated entity no longer requires incorporation. A single, or one-track, system would also be much simpler, eliminating (among other things) the need for new businesses to seek tax advice at the outset and the need for shareholder eligibility and one class of stock rules that, if not complied with, will cause an S corporation to be taxed as a regular corporation. Simplification would also have the benefit of facilitating the ability of the Service to audit the income and loss of passthroughs.

A single-track system would also likely lead to the elimination of the different payroll tax rules that apply to S corporation shareholders and partners in the partnership—a difference that for some taxpayers is an important factor in the choice between partnerships and S corporations.[106] It would make no sense to have different payroll tax rules for entities that were treated the same for personal income tax purposes simply because some were incorporated and others were not. A single-track system could also lead to serious consideration of what the operating rules should be—for example, whether the S corporation rules with respect to debt and allocations of income and loss are better than those that apply to partnerships. And some of the specific objections to the single-track approach in the Tax Reform Act of 2014, such as the rule that would require recognition of gain when a passthrough distributed appreciated property, do not justify two systems; any objectionable features of the single-

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the amount that would be ordinary income on a sale. *See* Tax Reform Act of 2014, *supra* note 87.

105. For what might be done in the absence of a single-track system, see Karen C. Burke, *Unified Reform Misses the Mark*, 2015 TAX NOTES TODAY 51-5 (March 16, 2015).

106. With an exception for limited partners and for certain investment income and rents, the income of a partner is generally subject to SECA, but an S corporation is seen as providing the opportunity to divide the S corporation's income between wages, which are subject to FICA, and the balance of the corporation's income which is not subject to either FICA or SECA. *See* I.R.C. § 1402; Reg. § 31.3121(d)–1; *see also* Rev. Rul. 74–44, 1974–1 C.B. 287; Radtke v. United States, 712 F. Supp. 143 (E.D. Wis. 1989). Additionally, the balance of the income would not be included in net investment income if the corporation's business was not a passive activity with respect to the shareholder.

track option contained in the draft reform act could be changed, if that was the consensus, without keeping the two-tracks system.

The price of simplicity, of course, is a loss of "flexibility"—that is, of some of the planning options of the present system. This is offensive to tax professionals (particularly if they have dedicated their careers to mastering the rules), and it seems to have been the core objection to the single-track system put forth by the Ways and Means Committee. There were also academic comments in favor of the two-tracks system[107] (although these oddly ignored issues such as the impact of payroll taxes on the choice between an S corporation and a partnership). For whatever reason, the idea of a single-track system (although not dead)[108] seems to have largely slipped away—the only change made by the 2016 Act was to accommodate the effort of the S corporation industry to reduce permanently to five years the period in which recognized built-in net gain would be taxed after a regular corporation became (or transferred assets to) an S corporation. If a single-track system ever moved forward, it might also make sense to consider whether non-publicly traded businesses should continue to have the option of being regular (i.e., C) corporations. [109]

An important issue for both partnerships and S corporations is the difficulty auditing returns filed by the partnership or the S corporation and of collecting any tax resulting from an audit from the partners or shareholders.[110] The Budget Reconciliation Act of 2015, enacted in November of 2015,

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107. *See* George K. Yin, *Comments on the Taxation of Entities*, 2013 TAX NOTES TODAY 142-10 (July 24, 2013) (referring to the 1999 ALI Reporters' Study on the Taxation of Private Business Enterprises and stating that "[a] 'two-track' approach to taxation . . . should be retained"); *see also* Deborah H. Schenk, *Reforming Entity Taxation: A Role For Subchapter S?,* TAX NOTES TODAY 46-4, (March 9, 2015) ("any uniform system of conduit taxation . . . complex enough to deal with complicated business arrangements is too complex for simple arrangements. Thus a two-track conduit system is appropriate . . . . Subchapter S should not be turned into subchapter K.").

108. *See* Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 TAX LAW. 345 (2016) (proposing a single system for privately held businesses, whether incorporated or not, and an entity-level tax that would be allowed as a credit to the owners when income was distributed, i.e., an imputation credit model of integrating the entity-level and owners' taxes).

109. This is an issue raised by the 1999 ALI Reporters' Study on the Taxation of Private Business Enterprises. *See* George K. Yin, *ALI Reporters' Study on the Taxation of Private Business Enterprises*, 1999 TAX NOTES TODAY 191-68 (Oct. 4, 1999).

110. This is generally not an important issue for RICs or REITs because audit adjustments that result in an increase in taxable income will result in tax at the RIC or REIT level unless paid out to shareholders as dividends, in which case the dividend will be taxable to the shareholders.

changed the rules for auditing partnerships, effective for taxable years beginning after 2017 and later years.

Absent special audit rules, adjustments to tax liabilities attributable to partnership income, gain or loss can only be made by auditing the partners' returns—that is, on a partner-by-partner basis. To deal with that, there are current rules for partnership-level audit in the case of "electing large partnerships" and separate rules (the so-called TEFRA rules) for other partnerships with more than ten partners. Neither works well—the electing large partnership rules because they are elective, and the TEFRA rules because they do not fully embrace partnership level audits—and both would be repealed when the provisions of the Budget Reconciliation Act of 2015 take effect.[111]

Under the audit rules of the Budget Reconciliation Act of 2015, partnerships would be audited by the Service and any deficiency in tax, as well as interest and penalties, would be assessed against the partnership.[112] Partnerships with 100 or fewer partners could, however, elect out of the rules, and in that case the Service would be limited to auditing and assessing each partner separately. Additionally, a partnership that did not elect out could, instead of paying any deficiency, elect to push out the deficiency to its partners by sending them revised Schedules K-1. This would require the partners to pay any tax due for the year in which the adjustment was made.[113]

While the new rules for auditing partnerships are a step forward, what is missing from the legislation is any system for auditing partnerships that have 100 or fewer partners and elect out of the new rules. Nor are there any rules for auditing S corporations, and no doubt the opposition to entity-level audit rules for partnerships with 100 or fewer partners was based on the view that audit rules for those partnerships would inevitably lead to entity-level audit rules for S corporations. To be sure, the TEFRA rules which now apply to such partnerships[114] have obvious defects, but these are in large part due to provisions that allow partners to participate in the partnership audit and require

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111. Less than one percent of "large partnerships," i.e., those with more than 100 partners, elect into the electing large partnership rules. *See* Gregory Korte, *IRS Audits Less than 1% of Big-Business Partnerships*, USATODAY.COM (Apr. 17, 2014), http://www.usatoday.com/story/money/business/2014/04/17/irs-audits-less-than-1-percent-of-big-partnerships/7842487/.

112. *See* JOINT COMM. ON TAX'N, JCS-1-16, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015, at 51–83 (2016).

113. For the background to these rules, see Donald B. Susswein & Ryan P. McCormick, *Understanding the New Partnership Audit Rules*, 149 TAX NOTES 1171 (Nov. 30, 2015).

114. There is an exception for partnerships with ten or fewer partners. *See* I.R.C. § 6321(a)(1)(B)(i) (as reenacted in 2015). The TEFRA audit rules originally applied to S corporations as well, but that aspect was subsequently repealed.

the Service to provide notice to partners and also due to complicated definitions (e.g., determining whether something is a "partnership item"). It makes no sense simply to repeal the TEFRA audit rules and not replace them with audit rules that apply both to partnerships with 100 or fewer partners and to S corporations.

D. Foreign Investment in the United States

The Tax Reform Act of 2014 did not address foreign investment in passthroughs or, more generally, inbound investment. It would seem to be sensible for the tax burden on income and gain from investments in US stocks or securities made by a foreign person to be the same whether the investment was made directly or through a passthrough, such as a RIC or a partnership. That is not the case under present law. While a foreign shareholder of a RIC is, with exceptions, generally taxed in the same way as if the shareholder directly owned the underlying stocks and securities,[115] a fund not registered under the Investment Company Act of 1940 cannot qualify as a RIC. S corporations are not available to nonresident foreign shareholders.[116] A partnership that is not publicly traded is the only way to achieve passthrough treatment. If a foreign person is a partner in a partnership that invests in or trades stocks and securities, however, the activities of the partnership (as well

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115. The rules with respect to foreign investment in shares of a RIC try to achieve parity of treatment with an investment in the underlying assets. Thus, distributions of gain, whether long-term or short-term, or of interest that would be exempt from withholding tax as portfolio interest, are not subject to US tax. *See* I.R.C. § 871(a), (k). Distributions of dividends are subject to the 30% withholding tax that generally applies to dividends, but this is ordinarily reduced by treaty to 15%. *See* I.R.C. § 871(k)(1)(B)(iii). The main exception is that, under a 2004 amendment to the RIC rules, a RIC may invest up to 25% of its assets in interests in "qualified" publicly traded partnerships. *See* I.R.C. § 851(b)(3)(B)(iii). While a direct investment by a foreign person in a publicly traded partnership would cause the partner to be engaged in a trade or business in the United States, and thus generally to be taxed on the partner's share of the partnership's income at regular rates, investing through a RIC avoids this and effectively converts the income from the partnership into dividend income.

116. An S corporation may not have nonresident alien shareholders, apparently because at the time the rules were enacted there was no immediately apparent solution to how the foreign shareholders should be taxed. This issue was addressed for partnerships in 1985 with the enactment of rules that in effect impose tax on the partnership in respect of each foreign partner's share of partnership income that is effectively connected with a US trade or business. *See* I.R.C. § 1446(a). An S corporation can, however, be a partner in a partnership with a nonresident alien, giving the individual essentially the same rights as a shareholder. *See* Reg. § 1.701–2(d), Example 2.

as the income or gain of the partnership) are attributed to the partner.[117] Because partnership activities are attributed to the partners, the partners may (unlike shareholders of a RIC) be engaged in a trade or business in the United States (and, if a treaty applies, be engaged in business through a permanent establishment). As a consequence, hedge funds and other partnerships that invest in or trade stocks and securities use complex structures involving separate entities, or "blockers," to channel investments both by foreign persons[118] and by tax-exempt investors concerned about leverage or other activities that might result in tax on unrelated business taxable income.[119]

The treatment of foreign investors in securities partnerships is an issue of growing importance—in the first quarter of 2014, hedge funds managed $2.7 trillion of assets, nearly double the assets at the end of 2008 and up from $200 billion at the end of 2003,[120] faster than the growth of RICs. Could the complexity that results from the present rules be significantly reduced if the RIC rules were extended to such a fund, even though not registered under the '40 Act, if it met the gross asset, gross income and distribution

117. *See* I.R.C. § 875(1) ("a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged").

118. *See* David S. Miller & Jean Bertrand, *Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers*, 65 TAX LAW. 309, § III (2012).

119. A tax-exempt organization that invests in securities through a partnership may, in contrast to a RIC (including a business development corporation), also have taxable "unrelated business" income because of partnership debt (which is attributed to the partners) and, in the case of investing in private equity funds, fees from portfolio companies (even if used to offset management fees owed the management company) as well as income from portfolio companies that are partnerships. *See* Mark E. Berkowitz & Jessica E. Duran, *Private Equity Funds and the Unrelated Business Income Tax*, 2015 TAX NOTES TODAY 212-10 (2015). These concerns lead, again, to complicated structures involving investments through blockers. *See* Ted Dougherty & Jay Laurita, *UBIT Reform Could Help Close the Pension Gap*, 150 TAX NOTES 1175 (Mar. 7, 2016) ("The current [unrelated business income tax] rules force pension plans to either pay [the tax] or engage tax advisers to create foreign blockers to avoid paying [the tax] while suffering dividend withholding tax. Both approaches harm investment returns for pension plans that are simply carrying out their tax-exempt purpose by investing . . . .").

120. In April 2014, HFR, Inc., an industry tracker, reported first quarter growth at a new peak of $2.7 trillion, nearly double the assets managed in 2008. *See* HFR, Inc., *Global Hedge Fund Industry Report*, MANAGED FUNDS ASS'N. (July 2014), https://www.managedfunds.org/industry-resources/industry-research/global-hedge-fund-industry-report-hfr/.

requirements?[121] There are other possible solutions, such as limiting the extent to which activities of securities partnerships are attributed to foreign and tax-exempt partners. These would certainly be worth considering.

E. *Foreign Investment in United States Real Estate*

The rules for foreign investment in real estate also distort investment decisions by disproportionately favoring investments through REITs (or, to put it the other way around, by putting investments made directly or through partnerships at a tax disadvantage). For some—foreign governments, foreign pension plans, and foreign real estate investors—investing through a US REIT is the only rational alternative.

Broadly, under the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA, the net gain of a foreign person from the disposition of an interest in US real property is taxed as income derived from a US business,[122] and, for this purpose, an interest in US real property is defined to include an interest in a "United States real property holding corporation"[123] other than solely as a creditor.[124]

There are a number of exemptions from FIRPTA, none simple. First, there is an exemption for gain from a sale of shares of a US real property holding corporation if the shares are regularly traded on an established securities market by a holder who owns (and in the last five years has owned) five percent or less of the class or, in the case of a REIT, ten percent or less of the class.[125] Second, under the 2016 Act, there is no longer any ownership

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121. The ability of a RIC to invest in publicly traded partnership would have to be addressed if this were done.

122. In the case of a foreign corporation, this may also result in branch profits tax.

123. In general, a US real property holding corporation is any US corporation if 50% or more by value of its gross real property and business assets consist of interests in US real property. I.R.C. § 897(c)(2). Equity REITs are generally US real property holding corporations. RICs may be US real property holding corporations because they may invest in shares of REITs.

124. If the US real property holding corporation is a REIT or a RIC, a distribution to a foreign shareholder of gain from the sale of US real property is treated for this purpose as gain recognized by the shareholder from the sale of US real property. I.R.C. § 897(h).

125. In the case of a distribution by a REIT or RIC of gain from the sale of an interest in US real property, an exception to the general rule treats the distribution as an ordinary distribution, not gain from the sale of real property, if the distribution is on shares of a class regularly traded on a US securities market to a holder who owns (and in the last 12 months has owned) five percent or less of shares of the class or ten percent or less in the case of a REIT. I.R.C. § 897(k)(1). Ordinary distributions (to the

threshold for gain of a "qualified shareholder" of a REIT, whether holding the shares directly or as a partner in a partnership, except to the extent that the qualified shareholder has investors (so-called "applicable investors") owning more than ten percent of the interests in the qualified shareholder. Thus, shares in a US REIT owned by a qualified shareholder are not interests in US real property, regardless of how much the shareholder owns. A qualified shareholder is a foreign person eligible for the benefits of a comprehensive income tax treaty (one which provides for the exchange of tax information) and whose principal class of shares is listed and regularly traded on one or more recognized stock exchanges,[126] is designated as a "qualified collective investment vehicle" by the Internal Revenue Service,[127] and is either fiscally transparent or allowed to deduct distributions to its owners.[128] Third, under the 2016 Act, there is now an exemption from FIRPTA for interests in US real property held directly or through a partnership by a "qualified foreign pension fund" or an entity all of the interests of which are held by such a fund.[129] Fourth, there is an exemption for gain from the sale of shares of a

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extent out of earnings and profits) are subject to withholding at a 30% rate or the 15% treaty rate. I.R.C. § 871(a).

126. Or (apparently as accommodation for Bermuda limited partnerships managed by Brookfield Asset Management) is a foreign partnership organized in a jurisdiction that has an agreement for the exchange of information and has a class of limited partnership units regularly traded on the NYSE or the Nasdaq that represents more than 50% in value of all of its units, and, in either case, is a "qualified collective investment vehicle" that maintains records with respect to five percent or greater owners. I.R.C. § 897(k)(3)(A)(i)(II).

127. Or is not so designated but is covered by a tax treaty that extends the reduced dividend withholding rate to more than ten-percent holders. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Australia-U.S., art. 10 (Oct. 31, 1983); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Netherlands-U.S., art. 10 (Dec. 31, 1993).

128. Or (in order to accommodate the publicly traded partnerships managed by Brookfield Asset Management) a "withholding foreign partnership," and would be a US real property holding corporation if incorporated in the United States. A "withholding foreign partnership" is a foreign partnership that has entered into an agreement with the Service to be the withholding agent in respect of payments it receives. Reg. § 1.1441–5T(c).

129. A qualified foreign pension fund is a foreign fund, including a public pension fund, that (1) is established to provide retirement or pension benefits for employees, (2) does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (3) is subject to foreign government regulation, (4) provides information reporting about its beneficiaries to the foreign tax authorities, and (5) receives tax benefits under the laws of the foreign country for the contributions to, and income of, the fund. I.R.C. § 897(l).

"domestically controlled" REIT or RIC. Domestic control requires that the REIT or RIC has been owned to the extent of more than 50% in value by US persons for the five years preceding the sale, or the shorter period since it was organized.[130] Finally, interest, dividends and gains from sales of stocks and securities realized by a foreign government—which generally include sovereign wealth funds and government pension plans—are not subject to US tax so long as not derived from an investment in a corporation that is a "controlled" commercial entity, even though the corporation is a US real property holding corporation.[131]

What are the consequences of these rules? A foreign government that invests in US real estate directly or through a partnership will likely be engaged in a trade or business in the United States if its activities or those of the partnership go beyond simple ownership and include the management of the investment, either directly or through agents. Thus, under general tax rules (without regard to FIRPTA) the government would be subject to regular rates of US tax on the income and gain from the investment.[132] As a consequence, foreign governments (which, as noted, generally include sovereign wealth funds and government pension plans) invest through REITs since that eliminates any entity-level tax on the income or gain and converts the income from the investment into interest, dividends, and gains from sales of shares of the REIT, all of which will be exempt from US tax so long as the foreign government does not "control" the REIT. Thus, there is no entity-level tax, no tax on gains from sales of shares, and no withholding tax on dividends or interest.

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130. There is no "constructive" ownership in determining whether a REIT is domestically-controlled. The owner of shares is the person required to take dividends into income and so, for example, a US subsidiary of a foreign investor may be the owner of shares that makes the REIT domestically controlled. The 2016 Act allows a publicly traded REIT or RIC to assume for this purpose that a five percent or smaller shareholder was a US person unless it had contrary knowledge, but the 2016 Act also provides that a shareholder that was itself a REIT or a RIC was not a US person unless the REIT or RIC was publicly traded and itself domestically controlled. Consolidated Appropriations Act, 2016, Pub. L. 114-113, § 323, 129 Stat. 2242, 3102.

131. I.R.C. § 892(2).

132. *See* Rev. Rul. 73–522, 1973–2 C.B. 226 (citing Lewenhaupt v. Comm'r, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); Herbert v. Comm'r, 30 T.C. 26 (1958), *acq*. 1958–2 C.B. 6; De Amodio v. Comm'r, 34 T.C. 894 (1960), *aff'd* 299 F.2d 623 (3d Cir. 1962)) (summarizing court cases as holding "that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular.").

A "qualified foreign pension fund" that invests in US real estate directly or through a partnership, although no longer subject to FIRPTA because of the 2016 Act, would likely be engaged in a trade or business in the United States if its activities or those of the partnership go beyond simple ownership and include the management of the investment, either directly or through agents. Thus, under general tax rules (without regard to FIRPTA) the fund would be subject to regular rates of US tax on the income and gain from the investment. This will obviously push the fund to make the investment through a REIT, blocking effectively connected income and eliminating any entity-level US tax. Dividends would be subject to withholding, but the typical US tax treaty would reduce the 30% rate to 15% if the fund owned 10% or less of the REIT, and the REIT is diversified.

A foreign REIT, if it invested directly or through a partnership in US real estate, would be subject to US tax on the income and gain from the investment, notwithstanding the 2016 Act, but if it invested through a US REIT there would be no entity-level US tax and, if it was a "qualified shareholder" with no "applicable investors" and a qualified collective investment vehicle, there would be no US tax on gain from the sale of shares of the US REIT. Dividends would likely be subject only to a 15% withholding tax if a treaty applied.

At the moment, the US tax treaties with the Netherlands and Australia extend the reduction in the rate of US withholding tax on dividends paid by a REIT to a shareholder that is the other country's equivalent of a REIT, regardless of the size of its investment in the US REIT.[133] As a consequence, a Dutch or Australian REIT will be a qualified collective investment vehicle and thus able to make investments in US real property through an essentially wholly-owned US REIT,[134] reducing the US tax on the investment to the treaty rate of withholding on the amount distributed as dividends by the US REIT. While the 15% treaty rate is available only to smaller shareholders,[135]

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133. In the case of an Australian REIT, this applies only to the extent it has 5% or smaller shareholders. *See* Convention for the Avoidance of Double Taxation, Australia-U.S., *supra* note 127, at art. 10.

134. Qualification as a REIT requires ownership by 100 or more persons, but, as noted, this is not a constraint as a practical matter and it is often satisfied by the issuance to the required number of outside investors of preferred stock representing less than one percent of the initial equity of the REIT. *See* Korte, *IRS Audits*, *supra* note 111.

135. Dividends paid by a REIT are subject to withholding at a 30% or the 15% treaty rate. *See generally* I.R.C. § 871. The 15% treaty rate generally is available only for dividends paid by a REIT (1) to an individual or pension plan owning 10% or less of the REIT, (2) on a class of publicly traded shares to the holder of 5% or less of any class of the REIT's shares, or (3) by a "diversified" REIT (no single property represents more than 10% of gross real estate assets) to a shareholder owning 10% or

eligibility would be determined at the level of the shareholders of the foreign REIT if for US tax purposes it was classified as a partnership, and as a consequence, the 15% would generally be available to a broadly-held foreign REIT.[136] A REIT or collective investment vehicle from a country other than Australia or the Netherlands may be able to achieve much the same result so long as it is covered by a comprehensive income tax treaty with the United States, regularly traded on one or more recognized stock exchanges, designated by the Service as qualified collective investment vehicle and fiscally transparent. There would then be no US tax on sales or other dispositions of shares of the REIT or on distributions that were not dividends.[137]

The effect of the complicated exemptions from FIRPTA is to favor, rather dramatically, investment in US real estate through a REIT rather than directly or through a partnership.[138] While regulations exempt from FIRPTA a sale of a five percent or smaller interest in a publicly traded partnership,[139] there is no exception for sales of interests in a domestically controlled partnership, nor is there an exception for a five percent or smaller partner's distributive share of partnership gain from the sale of real property. A foreign partner in a partnership owning US real estate will ordinarily be engaged in a trade or business in the US and thus taxable at regular rates of tax (i.e., those that apply to US persons) on the partner's share of the rent or other income of the partnership and required to file returns. There is no 15% rate on this income as there is in the case of dividends from a REIT to which a tax treaty applies.

Investing in a REIT will in most cases result in a withholding tax on dividends, but if the REIT is leveraged with debt from the shareholders, there would be no withholding tax on interest, assuming that a treaty with the shareholder's country eliminates (as most US tax treaties do) any withholding

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less of the REIT. *See* U.S. Model Income Tax Convention, art. 10 § 4, Nov. 15, 2005. There is sometimes a zero rate for pension funds but only in respect of dividends not paid by an "associated" REIT. Who is "associated" is generally determined by reference to I.R.C. § 482.

136. The 15% rate applies if, among other things, the beneficial owner of the dividends is an individual or pension fund holding an interest of not more than 10% of the REIT, or the beneficial owner of the dividends is a person holding an interest of not more than 10% of the REIT and the REIT is diversified, i.e., if the value of no single interest in real property exceeds 10% of its total interests in real property. *See* U.S. Model Income Tax Convention of 2006, art. 10, Nov. 15, 2005.

137. This structure was used before (although without the benefit of) the changes made by the Act by a number of Canadian REITs—e.g., American Hotel Income Properties REIT LP and Pure Multi-Family REI LP.

138. For some of the background to these changes, see Willard B. Taylor*, Is the Real Estate Investment and Jobs Act a Good Idea?*, 2015 TAX NOTES TODAY 168-8 (Aug. 31 2015).

139. Reg. §1.1445–5.

tax on interest. Additionally, if the shareholder is a partnership for US tax purposes (although not necessarily in the foreign country) the portfolio interest exemption from withholding tax will apply to interest that is paid to the partnership, regardless of how much of the REIT it owns, except to the extent there are ten-percent or greater partners of the partnership.[140] As a consequence, the effective rate of US income tax from the investment would be significantly lower than the 15% dividend withholding tax. The so-called earnings stripping rules would limit this only to the extent that related party interest deductions reduced taxable income, increased by depreciation and amortization, by more than 50%.[141]

What would make more sense than the piecemeal and distortive changes to FIRPTA made by the 2016 Act and the exemptions from FIRPTA that predated the 2016 Act would be to repeal FIRPTA altogether (or at least eliminate the "United States real property holding corporation" rules) and then to determine what is the appropriate tax burden to impose on foreign investment in US real estate, whether made directly, through a partnership or through a REIT. Not long after the enactment of FIRPTA, the rules that prompted its enactment were changed, making the US real property holding corporation rules and other features of FIRPTA largely unnecessary.[142] If FIRPTA was repealed, the US would then revert to a system that would tax gain from the disposition of real property owned by a foreign person if the property was used in a trade or business, but not otherwise. It would then be important to have rules that provided parity of treatment for investments in US real property that were made directly (including through royalty or other fixed investment trusts), through REITs, or through partnerships.

Existing investments in US real estate by foreign pension funds is made to a significant extent by pension funds that are "foreign governments" and thus already benefit from the exemptions that apply to the interest, dividends, and other investment income of a foreign government.[143] Wholly

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140. Reg. § 1.871–14(g)(3). The rule makes little sense since the purpose of excluding interest received by a ten-percent or greater holder was to deny the portfolio interest exemption to owners with significant control over the terms of the debt, and control is obviously present if the US REIT is largely owned by a partnership, even if it has no ten-percent or greater partners.

141. I.R.C. § 163(j).

142. Specifically, the repeal of *General Utilities* doctrine and the rules for deferred gain in Code sections 864(c)(6) and (7).

143. Section 892 exempts from US tax dividends, interest and gains from dispositions of stocks and securities unless received from a controlled commercial entity or from the disposition of stocks or securities of such an entity. A controlled commercial entity is one owned to the extent of 50% or more by voting power or value

apart from the objections to piecemeal changes to FIRPTA, the exemption for foreign pension funds, in the 2016 Act, if done at all, should plainly have been done on a reciprocal basis, whether by treaty or otherwise, and why it was done unilaterally is a mystery—even US pension funds may not get the same tax benefits from investments made through REITs as will be granted to foreign pension funds under the 2016 Act.[144]

VI. CONCLUSION

There is no question that the US federal income tax rules for classifying business entities need repair. As set out above, repairs might address the impact of the growth of passthroughs on the corporate income tax, the disparate treatment for corporate income tax purposes of some REITs and publicly traded passthroughs, the adoption of one set of rules for non-publicly traded partnerships and S corporations, and the different treatment of foreign investors in stocks, securities, and real estate. These are only a few of many issues.

Whether this will ever happen, of course, depends in part on whether there will be broader tax reform, addressing, for example, the difficult issue of how to deal with foreign income of US corporations and the rate of the corporate tax. Significant passthrough reform cannot as a practical matter be expected other than as part of broader reform that deals with these other issues. But even with broader tax reform, there seems at the moment to be little appetite for addressing the issues outlined in this paper. The growth of REITs to include actively conducted businesses has not attracted much congressional attention outside of the Tax Reform Act of 2014. The modest changes affecting REITs, which were made by the 2016 Act essentially to pay for a relaxation of the FIRPTA rules that applicable to foreign shareholders of US REITs, are hardly reform, and the Act's relaxation of the FIRPTA rules dramatically favors REITs as investment vehicles.

The partnership audit provisions for large partnerships that were made in the Budget Reconciliation Act are clearly a step in the right direction, but the Act also repealed, and did not replace, the TEFRA provisions that provided for partnership level audits of smaller partnerships. Why was that? The TEFRA audit rules are complicated and flawed, but most of the flaws resulted from provisions that gave the partners a voice in the outcome of an audit of the partnership. It made no sense simply to repeal those rules and, in effect,

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in which the foreign government has an interest that gives it effective control. I.R.C. § 891(a)(2)(B).

144. For example, a REIT that was owned by a few US pension funds would either fail the closely-held requirement in sections 856(a)(6) and (h) or, if it was leveraged, generate unrelated business taxable income that was subject to tax because it was "pension-held."

exempt partnerships with 100 or fewer partners from unified, partnership-level audits. S corporations should also be covered by the entity-level audit rules.