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To Our Clients

Avoiding Double Taxes

Peter Canellos has written a stimulating article about the integration of corporate and shareholder taxes (i.e., avoiding double taxation of corporate earnings), leveraged buyouts and master limited partnerships. It is worth reading.

M. Lipton

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CORPORATE TAX INTEGRATION: BY DESIGN OR BY DEFAULT?

by Peter C. Canellos

In the struggle for tax reform, there is a continuing conflict between the desire to structure a logical tax system through express tax reform proposals and the recognition that imperfections in the existing tax system which are not dealt with through express tax reform are often remedied through "self help" schemes adopted by taxpayers and their counsel. Most reformers would prefer conscious rather than tolerated adaptation. Recognizing the delays and political compromises inherent in the legislative process, however, many are willing to accept the bending and stretching of existing rules to make them conform more closely to an economic ideal.

An example of the conflict between express and tolerated reform can be found in the history of the "mirror image" liquidation technique following repeal of the General Utilities rule in the Tax Reform Act of 1986 (the "1986 Act"). As is well known, the 1986 Act eliminated the last vestiges of the General Utilities doctrine by repealing the non-recognition rules contained in former Sections 336 and 337 of the Code. In the course of the legislative debate on this change, it was argued that corporate nonrecognition should continue to be available where corporate assets were disposed of in a carryover basis transaction. An example would be the distribution of a controlled subsidiary's stock pursuant to a complete liquidation of the parent. Since the General Utilities gain is locked into the subsidiary's assets, many would argue that there should be no recognition of gain to the parent upon the distribution of the subsidiary's stock. An exception for carryover basis transactions was not, however, grafted onto the statute. In response, many tax practitioners looked to a planning technique which had been used prior to the 1986 Act pursuant to which a corporate acquiror could purchase the target corporation through an array of subsidiaries, liquidate the target corporation into those subsidiaries in a complete liquidation, tax-free under Section 332 of the Code (taking into account the aggregate stock ownership rules of § 1.1502-34 of the Regulations). By disposing of stock of the mirror subsidiaries, the acquiror could sell off appreciated assets of the target corporation, including the stock of its former subsidiaries, without any corporate-level gain -- the General Utilities gain being preserved through the low basis in the assets of the mirror corporations.

This attempt to use a planning technique to achieve a result which many would have argued was a logical adjunct to General Utilities repeal, however, is regarded as controversial. Legislative history of the 1986 Act is conflicting on the issue whether the mirror liquidation technique survives the 1986 Act, and the Treasury Department recently announced that it would not resolve this issue by regulation. (See letter of Secretary Baker, dated December 9, 1986, reprinted in 33 Tax Notes 1703 (1986); see also Notice 87-2, January 6, 1987, dealing with so-called "son of mirror" transactions involving distributions of appreciated assets). Putting aside this interpretive question, what is significant for present purposes is that the improvised response itself raises serious policy implications. Unlike a true carryover basis election, the mirror technique is only available to an acquiring company. Thus, an acquiring corporation can buy the target corporation through a mirror structure and sell off its components without recognition of gain. The target corporation, however, does not have this ability and is therefore placed at a competitive disadvantage in any struggle for corporate control. Given this and other defects in the mirror technique, most reformers would agree that an express statutory provision regarding carryover basis would be preferable to an *ad hoc* response.

The conflict between conscious reform and an *ad hoc* response to current imperfect rules also permeates consideration of a major remaining tax reform issue -- the integration of corporate and shareholder taxes. A logical approach to the integration issue would be to examine all the legal alternatives, their merits and demerits (including revenue effects, enforcement, effect on various shareholder constituencies, etc.) and to adopt the best possible system. That approach has been attempted in the United States but without success. As the result, we are left with a formally unintegrated tax system in which taxpayers use ad hoc techniques to minimize the double tax burden. Two techniques which are being increasingly used to effect a sort of integration are (1) overleveraged transactions; and (2) master limited partnerships. Each of these techniques has the effect of minimizing income which would otherwise be subject to corporate tax in the hands of a publicly held corporation under the classic two-tier tax system. These techniques suffer from serious administrative difficulties as well as the potential for abuse. As these techniques become more widely used, the essential reform issue in this area will be whether to continue the slide towards ad hoc integration or make a last effort to adopt a conscious integration system, coupled with constraints on such alternative "made-to-order" techniques.

Discussed below are the theoretical underpinnings of integrated and unintegrated tax systems; the methods which have been contemplated in the past for achieving formal corporate integration; the impetus for achieving some element of integration resulting from changes wrought by the 1986 Act; a discussion of overleveraging and master limited partnership integration techniques; and a proposed legislative agenda.

Tax Theories Relating to Integration

With certain express exceptions, the Code adopts the "classic" or "two-tier" system for taxing corporate earnings. That is, a corporation pays tax on its income, and its shareholders pay a second tax when that income is distributed to them. The classic system is based on the theory that the corporation is a separate legal entity, with its own sources of capital, income and expenses. The corporation is not simply an agent for the aggregation of its shareholders' investments. Rather, it is a separate "being" which is an appropriate subject for taxation.

The theoretical support for a separate corporate tax is strongest where a public corporation is involved. A public corporation involves professional management and has interests which are not fully coincident with the interests of its shareholders, unlike the typical close corporation which functions more like an aggregate than an entity. It is significant in this regard that the classic system most commonly functions to impose a true double tax in the case of public corporations rather than private companies, which through one means or another find ways to mitigate the double tax burden.

Under the classic view, the increase in economic power represented by earnings of corporations (particularly public companies) can be considered an appropriate base for corporate taxation. The distribution of these after-tax earnings to the shareholders in turn represents income to them on their investment in corporate stock. In support of this view it may be argued that a public corporation does not suffer serious competitive disadvantage _vis-a-vis_ partnerships and proprietorships since it does not generally compete with such businesses but rather with other public corporations (domestic and foreign). In addition, it is arguable that the financial power of the public corporation is an advantage for which it should pay a tax tithe. This view is well summarized in the following position expressed by a Canadian governmental source in connection with its consideration of integration proposals:

> By and large, a Canadian widely held public corporation competes with other public corporations. In this league it is natural for the competition to bear a corporation income tax and we consider it likely that some level of corporation tax is passed on to customers in the price which the corporations charge for their

goods and services.*

The argument against the classic system and for some scheme of integration rests ultimately on the proposition that "people" pay tax but companies do not. In effect, this prevailing economic view reflects a consumption-tax bias and regards the corporate tax as an indirect tax on the shareholders rather than a cost of doing business which is passed on in whole or in part by the enterprise. Thus viewed, the corporate tax violates notions of "vertical equity" since it subjects to a uniform tax rate income earned indirectly by shareholders who may be in different tax circumstances. It also violates notions of "horizontal equity" in that an item of income earned by an individual through a corporation will be subject to a different effective tax rate than the same item of income earned directly by the individual or through a partnership.

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* Cited in Gourevitch, Corporate Tax Integration: The European Experience, 31 Tax Lawyer 65, 86 (1977). The Gourevitch article also cites at page 86 the following discussion by Profession A.J. Van den Tempel of the conduit theory of corporation taxation:

> It would mean a return to the ideas of the 19th Century - understandable at the time - according to which even the public company is nothing but the enterprise of all of its shareholders. In this conception, the company has no existence of its own. The profits retained by the company are considered as part of the current income of the shareholder, which he has deliberately left at the disposal of the company. This point of view is obviously contrary to reality.

In addition, integration is generally favored because it has the effect of reducing the incentive for using debt rather than equity capital which exists under the two-tier tax system. With mounting concern regarding the dangers of leveraging, there is increasing support among economists for eliminating double taxation on dividends. Finally, eliminating a second tax on dividends would arguably encourage distribution rather than retention of corporate earnings. This in turn would permit shareholders to make their own choice as to reinvesting corporate earnings, rather than having such determination made on their behalf by corporate management. Thus, some degree of corporate integration is supported by so-called "free-market" economists.

The "integrationists" predominate in the circles of economists of academia. However, it may be significant that, in practice, many of these economic benefits expected from integration have not actually been generated by those countries adopting integration or have been achieved only to a modest degree.*

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* See generally, Gourevitch, <u>supra</u>.

Formal Means for Achieving Integration

If it is determined that there should be some integration of corporate and shareholder taxation, the next issue is to choose among the range of techniques for achieving such integration. These techniques differ in terms of whether (i) double taxation is mitigated with respect to both retained and distributed assets; and (2) the actual taxpayer on corporate earnings is the corporation or the shareholder.

The purest form of integration is referred to as full or complete integration, and in effect represents the system of tax applicable to partnerships and S corporations. Under full integration, corporate earnings are attributed on some basis to shareholders who pay tax on them whether or not distributed. In turn, corporate losses flow through to shareholders for deduction by them subject to applicable restrictions on such flow through (such as basis rules, at risk rules, and the new passive loss limitations). The mechanics of existing full integration schemes differ. Thus, in the case of S corporations, the "entity" nature of the corporation predominates more than in the case of partnerships, which under Subchapter K are more often viewed as aggregates. As an example, the basis of corporate assets is generally not affected by sales of the S corporation's stock, whereas Section 754 allows for such an adjustment in the case of sales of partnership interests.

A scheme of complete integration was recommended in the 1977 Treasury Department study entitled "Blueprints for Basic Tax Reform". Under that system, the holder of corporate shares on the first day of the corporation's taxable year would be attributed all the earnings of the corporation for the taxable year. His basis would be increased by any allocated earnings, and would be decreased by distributions and losses. Where shares were sold during the taxable year, the seller would not be taxed on the current year's income, nor would he have any basis increase in respect of such income. Given the premise of "Blueprints" that capital gain and ordinary income would be taxed alike, the exclusion of current year's income was fully offset by the failure to increase basis for current year's income.

"Blueprints" dealt at length with the administrative difficulties of a fully integrated scheme. Thus, the problem of taxing shareholders on amounts not received was to be ameliorated through a system of corporate remittance of a floating rate "withholding" tax. This tax was to be considered paid on behalf of shareholders. The audit adjustment problem was to be solved by having the adjustment treated as an income or deduction item attributed to those persons holding shares on the first day of the year in which the adjustment was made. Despite these efforts to grapple with the problems of full integration, "Blueprints" never got off the drawing board. In this respect, it shares the fate of all other schemes for applying a full integration system to corporations in general. In this connection, full integration systems were considered and rejected by Canada and Germany for reasons of theory as well as practicality.

A second system of integration provides for a deemed paid credit for shareholders receiving distributions. The corporation is the initial taxpayer. In essence, tax paid by the corporation on distributed earnings would be attributed to shareholders. Distributions would be "grossed up" and the shareholder would apply the attributed tax as a credit against his tax on the "grossed up" dividend. In effect, this system taxes the shareholder in much the way in which United States domestic corporations are taxed on distributions from foreign subsidiaries. The credit system has been adopted in many foreign countries and represents the generally prevailing corporate integration system.

The credit system raises a number of serious issues. First, there is issue whether credit should be allowed only for corporate taxes actually paid. If so, integration has the effect of cutting back on corporate tax preferences such as investment tax credits, as well as possibly eliminating the benefit of foreign tax credits. Second, there is the issue whether tax should be paid by the corporation in connection with distributions (the advance corporation tax in the United Kingdom being an example). Such a tax payment assures that the Treasury will receive tax equal to the credit claimed by shareholders and represents in effect a corporate minimum tax applicable even if preferences would otherwise reduce the effective rate of corporate "mainstream" tax below the rate of attributed credit. A third significant issue is whether the credit should be made available to foreign shareholders in domestic corporations. Such credit has generally not been provided to foreign shareholders in the absence of tax treaties. Indeed, a major advantage of the credit system is the leverage which it provides to the taxing jurisdiction in negotiating favorable treaties with other countries.

A third system of integration reduces the corporate tax on distributed profits. This can be achieved by either a dividends-paid deduction or a split-rate system which taxes distributed earnings at a lower rate than retained earnings. The split-rate system had been used in Germany prior to Germany's adoption of the credit system. A dividends-paid deduction had been recommended in the 1984 and 1986 Treasury Department Tax Reform Proposals. This system of integration relieves corporate tax on distributed earnings at the corporate level rather than offsetting the second tax otherwise payable by shareholders. It raises some of the same issues discussed above in the case of the credit system. In addition, it raises other serious concerns. First, unless measures are taken to alter this result, a dividends-paid deduction or split-rate system has the effect of allowing corporate earnings to pass untaxed to shareholders who are not taxpayers (e.g., tax-exempt organizations and foreign shareholders). The Treasury Department's 1980 tax reform proposals would have sought to recapture some of the tax lost as the result of distributions to foreign shareholders by imposing a special withholding tax on dividends qualifying for the dividends-paid deduction. It acknowledged, however, that such a withholding tax would violate most existing tax treaties.

A final system for achieving integration with respect to distributed earnings is to exclude such distributions from the recipient's income.* This system would permit a shareholder to exclude from income dividends paid from a "previously taxed income" account. Issues raised by this

* An analysis of this approach is contained in Peel, A Proposal for Eliminating Double Taxation of Corporate Dividends, 39 Tax Lawyer 1 (1985).

system of integration include whether a selling shareholder should receive a basis increase for undistributed, previously-taxed income allocated to his account; and the allocation of distributions among the categories of previously-taxed income, pre-integration earnings, and earnings accumulated after integration which had not been previously taxed (for example, because of corporate tax preferences).

As this short summary demonstrates, difficult issues must be considered and dealt with in determining which, if any, path to express integration should be taken. Typically, the integration scheme which is adopted is tailored to meet the needs of the particular taxing jurisdiction -- its historic tax system, the nature of its capital markets, the role of inward and outward international investment, and other factors. Where integration was adopted, it followed a long period of scholarly analysis and political input. Much of that work has already been undertaken in the United States. Despite these efforts, however, we are no closer to formal integration than we were in the sixties. Indeed, the 1986 Act has gone in the opposite direction by increasing the relative burden of corporate as compared with individual income taxes.

The Corporate Income Tax in the 1986 Act

Prior to the enactment of the 1986 Act, the classic two-tier system operated in such fashion as to prevent the imposition of a full double tax. Indeed, in many cases, the result was a lower tax burden than would be borne by individuals earning the corporate income directly. Prior to the 1986 Act, corporate income was taxed at a marginal rate of 46% with the effective tax rate being much lower because of the prevailing corporate tax preferences. With individual capital gains being taxed at a 20% rate, the aggregate tax on corporate earnings taxed and retained by a corporation and realized by the shareholder upon sale of his stock was 56.8%, not substantially greater than the 50% personal income tax rate. In addition, the *General Utilities* doctrine generally facilitated corporation acquisitions in which, at the cost of a single 20% shareholder capital gain tax, unrecognized corporate gain could be eliminated in the hands of a new shareholder. This factor, coupled with the fact that corporate earnings effectively bore less than a 46% tax rate as well as the possibility of a tax-free step up on death, often made the classic system a shelter rather than a burden.

As has been widely noted, the 1986 Act has changed the game considerably. At the same time that integration through the dividends-paid deduction was dropped (principally for revenue reasons), the corporate income tax became a relatively more substantial part of the tax calculus. The corporate income tax rate of 34% now exceeds the individual tax rate of 28% (in each case effective 1988). In addition, the elimination of the capital gains preferences means that corporate earnings which are distributed to shareholders or which are recognized by shareholders on sale of their shares will be subject to a much higher tax rate than would be the case if they were earned by the shareholder directly. In effect, $100 earned directly by an individual leaves him with $72 after federal tax. $100 earned by a corporation and realized by a shareholder on distribution or upon sale of his stock will leave him with only $47.52. In addition, repeal of the <u>General Utilities</u> doctrine means that this double tax burden will also effectively be imposed on unrealized corporate gain (whether in the acquisition transaction or on a deferred basis in the event that the corporation's basis in its assets carries over to the acquiror). Moreover, reduction of the corporate dividends-received deduction from 85% to 80% and tightening of rules relating to interest expense allocated to dividends received increases the <u>triple</u> tax paid on earnings of a corporation filtered through a second corporation. Finally, the adoption of a much more stringent corporate alternative minimum tax, which includes in its base half of the excess of book earnings over taxable income, may result in a substantial additional tax burden borne by corporate earnings as compared with individual earnings.

The increased relative tax burden on corporate earnings resulting from the 1986 Act has generated a searching inquiry into informal techniques for eliminating tax on corporate earnings. These techniques have been used in the past. They threaten to become even more widely used in the future, however, as the full impact of the classic two-tier tax as modified by the 1986 Act becomes evident. One of these techniques involves eliminating the tax on corporate income through substituting debt for equity in the corporation's balance sheet. The second calls for operating through a publicly traded "master limited partnership" a business that would normally be conducted by a publicly held corporation.

Corporate Leveraging

One widely recognized feature of the two-tier tax system is the incentive it provides for borrowing rather than issuing stock. This phenomenon has become an important element of many recent acquisitions transactions, including leveraged buyouts and leveraged recapitalizations. Many leveraged buyout transactions benefitted in the past from the ability to step up tax basis through the *General Utilities* rule (prior to its repeal) or through the now questionable mirror image technique. The essential hallmark of the leveraged buyout transaction, however, has been the substitution of debt for equity in the corporate balance sheet.

In the leveraged buyout transaction, a public corporation is acquired through a merger with or into a newly formed corporation, most of whose capitalization consists of debt. Very often the aggregate debt to equity ratio in the leveraged buyout company reaches astronomical ranges (*e.g.*, 100:1) not found in normal operating corporations. Often the debt is arranged in tiers, with senior bank lending forming the most secure tier and a layer or layers of junior subordinated debt making up the bulk of the remainder of the capitalization. Only a thin equity cushion supports the subordinated debt, and the subordinated debt in turn supports the bank debt.

A variation on the leveraged buyout transaction is the leveraged recapitalization. In this transaction, a shell corporation merges into the publicly held target corporation. On that merger, shareholders receive cash or other taxable consideration having a value equal to a large part of the value of their former stock interest, together with a residual stock interest in the surviving corporation. To avoid dividend treatment, newly issued shares are sold to investors, with the effect of such sale being to dilute the existing shareholders to a percentage interest less than 80% of their former percentage interest, and thus qualifying the transaction for sale or exchange treatment under Section 302(b)(2) of the Code. The leveraged recapitalization does not involve any change in asset basis; nor does it convert the corporation in question into a privately held company. Thus, it represents the leveraging phenomenon in its purest form.

Existing tax law constraints on leverage are ineffectual. While the Secretary of the Treasury has authority to promulgate regulations under Section 385 to deal with the debt-equity distinction, the several efforts to do so have failed. Section 279 of the Code imposes some limits on acquisition indebtedness but its many qualifications render it a trap for the unwary rather than an effective constraint. The interest deduction is not affected under Section 279 unless the indebtedness (1) is issued to acquire the stock or assets of "another" corporation (thus precluding application of Section 279 to a redemption situation such as the typical leveraged recapitalization); (2) meets a statutory subordination test (being either expressly subordinated to substantial unsecured debt or subordinated to trade creditors generally); (3) is either convertible into stock or issued together with warrants (but this test is not met if debt is issued with non-convertible stock); and (4) is issued by an overleveraged corporation not satisfying certain maximum debt-equity or minimum interest coverage tests.

Another common overleveraging transaction is the issuance of collateralized mortgage obligations by a thinly capitalized corporation. The Treasury Department has been troubled for some time by trust arrangements involving multiple classes of ownership interests (typically slow-buy, fast-pay) which divide ownership interests in a pool of mortgages. Its concern led to the promulgation of an amendment to Regulation § 301.7701-4(c), which generally treats such trusts as associations. In reponse to the controversy generated by that Regulation, Congress adopted the real estate mortgage investment conduit ("REMIC") provisions, which provide a statutory vehicle for multi-class mortgage pool arrangements. At the same time, Congress enacted Section 7701(i) of the Code, which provides for the exclusivity of the REMIC rules by treating as associations "taxable mortgage pools" established after 1991.

Treasury Regulation § 301.7701-4(c) attempts to limit the class of multi-interest mortgage pool vehicles.

Its purpose can be frustrated, however, through the use of thinly capitalized corporations which issue multiple classes of "debt" obligations supported by underlying mortgage pools. Again relying on the absence of authority treating straight debt not held by shareholders as equity for tax purposes, these arrangements in effect provide for an elimination of corporate level tax through a vehicle not specifically sanctioned by Congress. In new Code Section 7701(i), Congress attempted to preclude this end-run on REMIC exclusivity by taxing mortgage pools with multiple debt or equity classes.

An overleveraged capital structure represents a unique integration structure. First, it permits corporate earnings to be attributed to holders of "debt" instruments who may not be taxpayers, for example nonresidents, entities with large net operating loss carryovers, and tax-exempt pension trusts and foundations. In effect, overleveraging represents integration through an <u>unrestricted</u> dividends-paid deduction. It eliminates corporate-level tax without assuring that there will be any tax on the recipient of the distribution of earnings in the form of "interest." Second, unlike a typical dividends-paid deduction system for integration, overleveraging can eliminate corporate tax without actual cash payments to a distributee. Through the issuance of "debt" instruments bearing original issue discount, the corporation can create non-cash deductions which shelter corporate income to be used for corporate purposes, including payment of principal on other corporate debt. (This approach has been facilitated through the expansion of original issue discount concepts in recent legislation and proposed regulations to include, for example, most items of contingent interest.) In effect, this form of overleveraging represents integration on an accrual method, again without any assurance that the holder of the debt instrument will be a taxpayer with respect to the original issue discount generated.

In these and other respects, overleveraging represents the type of integration that would never be adopted consciously. It is allowed to exist because (1) rules to combat it are difficult to draft; and (2) there is some implicit desire to facilitate transactions that mitigate the corporate double tax burden.

Master Limited Partnerships

The master limited partnership is a device for achieving complete integration for income that would normally be earned by a public corporation subject to the two-tier tax regime. As previously noted, a complete integration scheme for public companies has been toyed with but never adopted by any tax jurisdiction. The reasons typically given for rejecting this approach are the extreme complexity which it entails, together with its complete repudiation of the public corporation's status as a separate economic entity. On the other hand, the traditional partnership subject to tax under Subchapter K flows through its profits to its partners in what amounts to complete integration. While the partnership is considered an entity for certain tax measurement and reporting purposes, it is largely taxed as an aggregate of its partners. Similarly, Subchapter S permits certain closely held corporations to elect a somewhat different scheme of complete integration. In the case of the traditional partnership and the Subchapter S corporation, the limited number of participants and other factors make aggregate taxation particularly appropriate. For this reason, partnerships and "close corporations" are largely taxed by foreign countries in a way different from public companies.

The master limited partnership is a partnership in form which has enough "partnership" tax substance to meet the very minimal tests set forth under the "Kintner" Regulations (§ 301.7701-3 of the Regulations) for taxation as a partnership rather than a corporation. Under these Regulations, a partnership formed under a uniform limited partnership act or a revised uniform limited partnership act will enjoy partnership status so long as the test of unlimited liability is satisfied, even if the corporate characteristics of free transferability and centralization of management are enjoyed by the entity. Unlimited liability in turn is invoked by having one or more general partners who have unlimited liability. The test of unlimited liability is satisfied even though the interests held by these general partners are minimal compared to other partners enjoying limited liability. Unlimited liability is achieved even though the general partner in question is a special purpose corporation so long as certain tests relating to the capitalization of that corporation are met.

There have been numerous proposals to change the Kintner regulations to tax publicly traded partnerships as corporations. This suggestion was contained in the American Law Institute's 1982 Federal Income Tax Project on Subchapter K. The 1984 Treasury Tax Reform Proposals would have treated as associations partnerships having more than 35 limited partners.

In the past, the master limited partnership format has largely been employed in transactions involving assets regularly generating cash flow, and the number of such partnerships has been relatively limited. Typically, master limited partnerships have owned oil and gas property, leased real estate, timber properties and other assets that require little management and involve (hopefully) little fluctuation in cash flow. Recently, master limited partnerships have proliferated (many having been recently filed with the SEC or being in the process of being filed). In addition, master limited partnerships have strayed into areas other than passive property ownership. Many of these areas involve the active conduct trades or businesses, including health care, food services, and athletic franchises. Thus, master limited partnerships conduct the types of business that could not be conducted through the public pass-through entities specifically contemplated by the Code (e.g., regulated investment companies or real estate investment trusts). Where an active business is involved, the public limited partnership often receive some assurance as to regular cash flows through the undertaking of the corporate sponsor of the master limited partnership to subordinate his share of cash flow or to make contributions to support distributions to the master limited partnership unit holders. With this undertaking, the master limited partnership becomes a powerful acquisition and financing device, especially given the anti-corporate bias of the 1986 Act.

In the past, master limited partnerships have been utilized, among other things, in connection with corporate liquidations in which gain was sheltered by former Sections 336 and 337 of the Code. With the General Utilities repeal that form of transaction has largely lost its appeal. However, certain recent articles have suggested other uses of a master limited partnership to facilitate avoidance of the General Utilities repeal in the 1986 Act. One format which has been discussed is for a corporation to contribute its business to a master limited partnership, take back interests to which are allocated the bulk of current earnings but little share in residuals. The remaining "residual" interests in the master limited partnership, or warrants to acquire the same, would be either distributed to the corporation's shareholders or sold to third parties. Through this medium, the corporation achieves a division between current earnings and residual prospects in such a manner as to allow the realization of future appreciation without corporate level tax.

Master limited partnerships can also be used as sophisticated financing devices. For example, a corporation could contribute its business to a master limited partnership taking back interests which would share in a small percentage of partnership earnings for a fixed period of time and thereafter in a much larger share of such earnings. The partnership in turn would sell to third parties interests which represent the remainder of the partnership earnings stream. The investor in such units might, for example, receive 95% of cash flow and earnings for a 15-year period, and then 5% thereafter. In this manner, the taxable income allocated and distributed to the holder of the purchased units would not be subject to corporate taxation. If the holder of those units were a tax-benefitted investor (e.g., a company with a net operating loss), corporate earnings would have escaped corporate tax. In effect, this arrangement represents a form of borrowing or assignment of income which arguably avoids the balance sheet impact of borrowing and the adverse tax consequences of an assignment of income.

Master limited partnerships raise extremely difficult and intricate issues under Subchapter K. A selected few of these issues are discussed below. In many respects master limited partnerships can only function by overlooking technical compliance with existing regulations. In other respects they accomplish their tax objectives only through the incorporation of new and sophisticated tax allocation techniques. While many of these devices are creative and consistent with the policies underlying Subchapter K, some of them raise serious policy questions. All of them involve inordinate complexity. As a result, the costs of operating a master limited partnership and having it comply to the extent feasible with tax rules is a substantial burden which makes master limited partnerships a pet project of tax lawyers and accounting firms.

Because master limited partnership interests can and do trade regularly and since such interests are often held in street name, strict compliance with tax rules relating to sale of partnership interests (e.g., Section 751 of the Code and Section 708 dealing with terminations) is practically impossible. Master limited partnerships also take some liberties with the allocation of income among periods; the allocation of basis among classes of assets under Section 755 of the Code; and the required periodic valuation of assets to satisfy Section 755 of the Code.

Most importantly, making sure that master limited partnership units are "fungible" on the public market requires some creative structuring. Thus, in a "roll out" master limited partnership in which the corporate sponsor receives interests in exchange for appreciated corporate assets while the public purchases units for cash, fungibility between the units originally sold for cash and the sponsor's units (in the event they are later to be resold) is threatened by the difference between the tax basis and book basis of the assets contributed by the corporate sponsor. While Section 704(c) is intended to leave the burden of such difference with the corporate sponsor, the "ceiling" rule contained in § 1.704-1(c)(2) of the Regulations (which does not reflect the Tax Reform Act of 1984) may prevent achievement of that goal.* Because of the ceiling rule, part of the inherent gain on property contributed by the sponsor may wind up taxed to the public unitholder. Even more importantly, because of the ceiling rule, a purchaser of a unit originally sold to the public may receive less depreciation (or more gain) with respect to the appreciated property than a purchaser of the sponsor's unit who obtains a separate step-up in asset basis as the result of a Section 754 election.

Master limited partnerships attempt to avoid the ceiling limitation by making what are called "curative" allocations of gross income, solely for tax purposes, in order to permit the full burden of the book-tax disparity to be borne by the corporate sponsor and thus effectively to provide an equal flow of depreciation for purchasers of public units and purchasers of sponsor units. Such allocations, though they conflict with the literal language of the Section 704(b) Regulations (since they are not given book effect), should probably be recognized since they achieve the objective reflected in revised Section 704(c) of eliminating book tax disparities as soon as possible.

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* A similar problem exists in master limited partnerships which make successive primary public offerings. At the time of the follow-on public offerings partnership assets are re-booked to fair market value pursuant to § 1.702-1(b)(2)(f) of the Regulations, which generate so called "reverse Section 704(c)" allocations raising the "ceiling rule" and other problems discussed in text.

"Curative" allocations do not in themselves assure fungibility. When a corporate sponsor sells his interest, burdened by a Section 704(c) allocation, to a third party investor, that unit is fungible with others in the market only to the extent that Section 754 provides the purchaser with a stream of depreciation equivalent to that which he would have enjoyed had he purchased a unit that benefitted from a Section 704(c) allocation (and curative allocations). In turn, this calls into play the existing Regulations under Section 743 of the Code and the Proposed Regulations under Section 168 of the Code. Regulation § 1.743-1(b)(1) provides that the Section 743 adjustment in the amount of the difference between the purchaser's basis in his partnership interest and his share of the partnership's common basis in its assets, taking into account any shifting of common basis under Section 704(c) of the Code. Under the proposed § 168 Regulations, a special basis increase under Section 754 is treated as a new property addition, generating depreciation under the rules prevailing at the time of the purchase of the unit rather than additional depreciation on the same basis, method and period as was being claimed in respect of the common basis in partnership assets. See § 1.168-2(n) of the Proposed Regulations. (A decrease in basis reduces depreciation over the historic depreciation period.) Accordingly, under the Proposed Section 168 Regulations, the depreciation flowing through the Section 754-adjusted unit would not be equivalent to the depreciation flowing through other units in the market, which receive a larger share of common-basis depreciation under Section 704(c).

Master limited partnerships take the position that, to the extent of the "booked-in" depreciation inherent in the sponsor's unit, depreciation should be taken on the same method as is being used by the partnership for its common basis in partnership assets. The theory in support of this approach is that it is consistent with the purposes of Section 704(c) and puts the purchaser of the sponsor's unit in the same position that would have prevailed had the sponsor originally reported gain on the transfer of the partnership interest. On the other hand, it has the effect of permitting aggregate depreciation deductions to be claimed under the partnership's historic tax accounting method in excess of those which could have been claimed under that method but for the Section 754 event. In essence, the partnership is manufacturing additional grandfathered depreciation. This is the flip-side of another troublesome aspect of partnerships -- namely that a new partner can inherit the grandfathered depreciation and other tax methods of a partnership to the extent of his common basis in partnership property. (Unlike the problem previously discussed, this one arises because the partnership is viewed as an entity rather than an aggregate for this purpose.) Some recent changes in law have attempted to deny grandfather status to a purchaser of a partnership interest even in the absence of a termination in partnership. See Section 503(c)(2) of the 1986 Act, extending the at-risk rules relating to real estate to partnership interests acquired after the effective date.

This extended discussion involves only one aspect of one problem raised by the application of Subchapter K to master limited partnerships. The master limited partnership approach to partnership allocations is, as previously noted, creative and in some respects controversial. It could be said in defense of some of these techniques that they have refined and made more logical some of the partnership allocation rules, especially those relating to contributed property. What is most significant, however, is that the master limited partnership approach has as its prime goal the achievement of an objective which Subchapter K should not particularly be concerned with -- fungibility of limited partnership units. In essence, to achieve the fungibility which stock in a corporation has because of the corporation's status as an entity, the master limited partnership pushes the aggregate concept of a partnership to and beyond its limits.

The complexities of Subchapter K revolve principally around the aggregate-entity distinction. In many respects, Subchapter K represents a compromise between these two different ways of viewing a partnership. In the traditional partnership it is insignificant whether partnership interests are fungible since they are never designed to trade as fungible. While it is a laudatory objective to eliminate traps for the unwary which may result from the purchase of one partner's interest rather than another, the nature of an untraded partnership does not make the avoidance of this problem a great priority. In the master limited partnership context, however, fungibility becomes the be-all and end-all. Master limited partnerships cannot function unless the units are fungible for such fungibility allows them to trade as stock trades. Thus, master limited partnerships inject a concern into partnership taxation which, at the very least, adds complexity to an already overly complex area and, in many cases, causes results which are problematical in terms of tax policy.

The issues regarding partnership allocations pale into insignificance, however, compared with the compliance issues raised by the master limited partnership. It must be remembered that the master limited partnership generates income which in the normal case would have been reported by a C corporation. C corporations have corporate tax departments which are sophisticated and which rely upon expert advice. Also, the C corporation is there to pay the tax. The income that would be reported by the C corporation is, in the master limited partnership context, allocated to a member of the public at large, who often holds through a street-name arrangement. Even though information reporting requirements under Section 6031(c)(1) of the Code now compel the nominee to supply certain tax information to the partnership, it is too much to expect that the level of compliance will approach the level that should be assumed in the case of the C corporation. A substitution of information reporting for C corporation taxation is analogous to removing a withholding tax system and substituting information reporting. Recent experience with information reporting regarding capital gains suggests that information reporting is no substitute for tax in the till. There is no reason to believe that the level of compliance on the part of master limited partnership units will be any higher than for other Form 1099 type items.

The compliance problems become even more serious when audit adjustments are taken into account. So long as master limited partnerships held relatively passive interests rather than operating active businesses, this problem had somewhat less significance. The new generation of master limited partnerships often conducts the kinds of businesses, involving employee costs, inventories, depreciation and other timing items, that are typically reported on C corporations returns. Undoubtedly, there will be more audit adjustments relating to master limited partnerships. This would be so even if the master limited partnerships employed conservative reporting rules, as many have assumed (rightly or wrongly) that they do. Consider, for example, a manufacturing business operated through a master limited partnership which changes its accounting method as a result of an Internal Revenue Service audit, with a Section 481 adjustment spread over a number of years. The effect of the audit adjustment may be to change the taxable income previously reported or to be reported by holders of master limited partnership units over a five or ten year period. Even with TEFRA partnership audit procedures, the result will be a nightmare in terms of open tax years for unit holders. In addition, the cost of collecting the relatively small amounts of tax that may be payable by each unit holder could be astronomical. For these, among other reasons, it is clear that no business would be conducted in master limited partnership format unless the tax consequences inherent in this form of integration outweighed operating and other disadvantages.

The recent proliferation of master limited partnerships suggests that tax consequences are sufficient to drive this format despite its complexities and difficulties in operation. In a sense, when public C corporations compete mainly with similarly taxed C corporations the penalty of a two-tier tax may be offset by the financing and other advantages available to a public entity. The publicly traded partnership, however, creates "unfair competition." It can be argued that Congress should be concerned with the tax advantages of the publicly traded partnership as it was with competitive advantages of tax-exempt entities which traded on their exemptions prior to the enactment of the tax on unrelated business income. The proliferation of master limited partnerships can also have an adverse effect on capital markets. Currently, capital markets, at least on the equity side, involve shares of corporations which can be held without peculiar tax or other detriment by all classes of holders, including tax-exempt investors and foreign investors. If master limited partnerships displace public corporations in large part, a whole class of equity investment will be foreclosed to such investors. This could result in entire industries being separated from international capital flows. In turn, this can only have disadvantageous consequences in terms of liquidity and capital markets.

A Proposed Legislative Agenda

By turning its back on express integration proposals, Congress has given impetus to numerous *ad hoc* integration forms including the overleveraging and master limited partnership transactions described above. If Congress has avoided integration for revenue reasons, it may well turn out that equivalent tax revenues are being lost through informal integration without any corresponding increase in the rationality of the tax system. Moreover, the ability to avoid corporate taxation through these techniques removes some of the pressure which might otherwise lead to true reform. Indeed, *ad hoc* integration would seem to be leading to less rational tax structures, more tax revenues lost and increasing burdens of compliance and reporting.

In the master limited partnership context, operating difficulties may result in calls by sponsors to liberalize the partnership tax rules to facilitate the functioning of these increasingly prevalent entities. In effect, Congress and the Treasury Department would be asked to take steps to bless that which had only previously been tolerated. This development would make it even more difficult to switch to an express system of integration in the future.

In addition, the longer we wait before displacing *ad hoc* integration with formal integration the more difficult will be the process of dealing with entities established before the change in rules. It can be expected that sponsors of master limited partnerships will argue for perpetual entity grandfathering of master limited partnerships established prior to the effective date of the new rules. If this approach were followed, there would be a large class of grandfathered master limited partnerships, which might achieve greater degrees of integration than the express integration adopted by Congress. This would be analogous to the benefits retained for many years by the China Trade Act and Western Hemisphere Trade Corporation, long after their benefits were denied to new entities. An alternative would be to provide for the treatment of master limited partnerships as corporations on a certain date following enactment of express integration provisions. This could be combined with provisions facilitating restructuring of master limited partnerships. This approach was taken by the Treasury in connection with the revocation of the so-called "cost company" rulings, which had permitted jointly owned mining corporations to be treated as conduit entities. *See*, *e.g.*, Revenue Ruling 77-1, 1977-1CB 161; Revenue Ruling 56-542, 1956-2CB 327; L.R. 802208; L.R. 801742.

For these reasons, it is essential that Congress give consideration to the various express integration techniques previously described. It should take into account the effect on inward and outward foreign investment, tax preferences, capital formation, tax revenues and enforceability and other factors. In this analysis, tax revenue costs should take into account whatever revenue savings can be generated by restricting, in the manner set forth below, the <u>ad hoc</u> integration schemes previously described. In effect, revenues saved through eliminating overleveraging and master limited partnerships can help to subsidize conscious integration efforts.

Whatever the results of this inquiry, the system adopted -- whether it be retention of the classic system, or some form of limited or full integration -- should generally be made exclusive. As the result, the taxation of business enterprises should fit into the following categories:

(1) The "normal" tax system applicable to a C corporation. This might (although this is probably unlikely) be full integration. More likely, there would be a shareholder credit or deduction, or a corporate dividends-paid deduction.

(2) Unless full integration is adopted, the existing special-purpose integration vehicles under current law

should be preserved. These include regulated investment companies, real estate investment trusts and REMICs.

(3) If complete integration is not adopted for C corporations, there should be elective "close corporation" full integration. Under this approach, a corporation or partnership having fewer than a specified number of shareholders or partners should be able to elect either Subchapter S and Subchapter K treatment. The permissible number of participants could be increased from the 35 person limit applicable to S corporations under present law to, say, 100. In addition, certain of the qualification requirements for S corporation status could be liberalized.

(4) Corporations not meeting the "close corporation" rules would be taxed as C corporations. Partnerships not meeting the "close company" rules would be taxed as C corporations if more than a specified percentage of their partnership interests (by value) were either (a) publicly traded or (b) held as limited interests by a greater number of partners than is permitted by the "close corporation" exception described above. The effect of including category (b) is to respond to the argument that publicly traded partnerships are no different than many large partnerships held by hundreds of limited partners who acquired their interests in private placement transactions. Both categories of large

partnerships are likely to involve an "entity" having a real division between management and ownership which typically prevails in a public corporation, rather than a true aggregate or joint enterprise.

(5) Finally, limitations on leverage should be adopted either under Section 385 of the Code or through an expansion of Section 279 of the Code. The objective in either case would be to reduce overleveraging by denying interest deductions where debt-equity ratios substantially exceed the debt-equity ratios prevailing in the industry in question. In this manner the use of overleveraging as a means to achieve greater integration than is provided for by law would be eliminated.

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