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# Passthrough Entities: The Missing Element in Business Tax Reform

Karen C. Burke\*

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## I. INTRODUCTION

Reform of the U.S. corporate tax system is again on the agenda. Despite important differences, many current proposals share two common goals: (1) reducing the statutory corporate tax rate to improve U.S. “international competitiveness” and (2) broadening the corporate tax base by reducing or eliminating business expenditures to offset revenue losses.<sup>1</sup> Given the significance of the passthrough sector and the relationship between individual and corporate taxes, however, such reforms need to be considered within a broader context.<sup>2</sup> Part II of this Article discusses the growing

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1. See, e.g., H. COMM. ON WAYS & MEANS, 112TH CONG., TAX REFORM ACT OF 2011 (Discussion Draft 2011) (Camp proposal); WHITE HOUSE & DEP'T OF TREAS. REP., THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM (2012) [hereinafter FRAMEWORK] (Obama proposal); cf. Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?*, 65 TAX L. REV. 323, 323 (2012) (characterizing “international competitiveness” as “a concept that is almost always simply asserted and virtually nowhere defined”).

2. See George A. Plesko & Erin E. Henry, *Some Devilish Details of Corporate Tax Reform*, 21 KAN. J.L. & PUB. POL'Y 382, 383 (2012). See generally CONG. BUDGET OFFICE, Pub. No. 4298, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX (2012) [hereinafter CBO, TAXING

significance of the passthrough sector, which now accounts for roughly half of net business income. Part III explores new incentives for retaining corporate earnings and mischaracterizing labor income that would arise from an increase in individual income tax rates coupled with a simultaneous decrease in corporate tax rates, and considers the feasibility of measures to curb such sheltering within corporations. Finally, Part IV urges Congress to look beyond reducing business expenditures to expand the corporate tax base and recommends consideration of an entity level tax on certain large partnerships.

## II. RISE OF PASSTHROUGHS

Prior to the 1986 Act, the two-tier corporate tax system often functioned as “a shelter rather than a burden.”<sup>3</sup> Even though corporate income was taxed twice—once at the corporate level and again at the shareholder level—the effective tax rate was often less than the highest statutory rate for corporations (46%).<sup>4</sup> Distributions qualifying for capital gain treatment bore at most a 20% tax, which could be avoided entirely if the stock were held until death.<sup>5</sup> The 1986 Act largely eliminated the use of corporations as shelters by setting the corporate tax rate (34%) higher than the individual rate (28%) and taxing capital gains at the same rate as ordinary income.<sup>6</sup> The increased relative burden of the corporate tax encouraged self-help integration through the use of passthroughs, as well as the expansion of publicly traded “master limited partnerships.”<sup>7</sup> In 1987, Congress sought to prevent further erosion of the corporate tax base by enacting § 7704, which classifies a publicly traded partnership as a corporation, subject to a passive income exception.<sup>8</sup>

Following the 1986 Act, individual income tax rates rose, narrowing the differential between the corporate and individual rates and eventually surpassing the corporate rate in 1993. In 2003, parity was established between the maximum corporate and individual rates, and dividends were

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BUSINESSES].

3. Peter C. Canellos, *Corporate Tax Integration: By Design or By Default?*, in CORPORATE TAX REFORM: A REPORT OF THE INVITATIONAL CONFERENCE ON SUBCHAPTER C 129, 135 (George K. Yin & George Mundstock eds., 1988).

4. *Id.*

5. Thus, assuming a 20% capital gains rate, the maximum combined corporate and shareholder tax burden (56.8%) was not significantly above the top personal income rate (50%). *Id.*

6. The 1986 Act also repealed the so-called *General Utilities* doctrine, which allowed corporations to distribute appreciated property without recognition of corporate level gain. See *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

7. See Canellos, *supra* note 3, at 136.

8. See I.R.C. § 7704(a), (d). Unless otherwise indicated, all I.R.C. citations refer to the Internal Revenue Code of 1986, as amended through January 2, 2013.

temporarily taxed at the same rate as long-term capital gain. The shareholder level tax on distributions generally makes corporations less attractive than passthroughs, which have become more widely available.<sup>9</sup> In 1988, the Internal Revenue Service recognized that state-law limited-liability companies (LLCs) could be classified as partnerships for tax purposes.<sup>10</sup> The enactment of § 7704 helped to facilitate the check-the-box regulations, finalized in 1997, which allow unincorporated private business firms to freely elect corporate or partnership status.<sup>11</sup> By eliminating the linkage between organizational form and tax status, the check-the-box regulations undermine the justification for multiple passthrough regimes.<sup>12</sup>

Passthroughs have clearly become the vehicle of choice for nonpublicly traded businesses. Prior to 1986, partnerships were popular mainly as tax-shelter vehicles because of the opportunity to pass through losses and credits to passive investors. The 1986 limitations on passive losses temporarily reduced the attractiveness of partnerships.<sup>13</sup> Now partnerships are increasingly used by profitable ventures, with their share of net business income rising from 3% in 1980 to 21% in 2008.<sup>14</sup> In part, this trend reflects the increasing popularity of LLCs and other limited-liability entities taxed as partnerships under the default classification rules. During this period, the share of net income received by all passthroughs rose from 21% to 50%.<sup>15</sup>

Following the 1986 Act, commentators predicted the demise of S corporations, which are simpler but less flexible than partnerships. Nevertheless, these entities have proven enormously popular. Between 1980 and 2006, the percentage of businesses organized as S corporations tripled, increasing from 4.2% to 12.6%.<sup>16</sup> The growth of S corporations is partly

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9. If dividends are taxed at 15%, the maximum combined corporate and shareholder tax burden is 44.75%. See *infra* notes 71–72 and accompanying text.

10. See Rev. Rul. 88-76, 1988-2 C.B. 360 (1988).

11. See Treas. Reg. § 301.7701-3 (2012).

12. Nevertheless, simplification of the entity classification rules has no political constituency. See Williard B. Taylor, “Blockers,” “Stoppers,” and the Entity Classification Rules, 64 TAX LAW. 1, 32 (2010) (noting that the major passthrough industries have lobbying agendas that are likely to lead only to greater complexity).

13. See I.R.C. § 469.

14. See Jane G. Gravelle & Thomas L. Hungerford, *Corporate Tax Reform: Should We Really Believe the Research?*, 121 TAX NOTES 419, 421 (2008).

15. *Id.* This figure includes sole proprietorships, partnerships, and S corporations. The rise of passthroughs was also spurred by the shift to a service-based economy. See CBO, TAXING BUSINESSES, *supra* note 2, at 10.

16. See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R40748, BUSINESS ORGANIZATIONAL CHOICES: TAXATION AND RESPONSES TO LEGISLATIVE CHANGES 12 (2009). Between 1980 and 2008, the percentage of businesses (including sole proprietorships) organized as C corporations

attributable to legislation expanding the number and type of permissible shareholders.<sup>17</sup> In addition, S corporations have an advantage in structuring employee-shareholder compensation because paying dividends in lieu of salary may avoid payroll taxes.<sup>18</sup> Regardless of their level of participation, S shareholders are thus on a par with limited partners who are permitted to exclude their distributive share of partnership income from net self-employment income.<sup>19</sup> By contrast, general partners are subject to self-employment tax on their distributive share of partnership income (with exceptions for specified types of income) on the theory that such partners are often actively engaged in the partnership's trade or business.<sup>20</sup> In the case of LLCs, it is unclear whether members should be treated as analogous to limited or general partners for employment tax purposes.<sup>21</sup>

The emergence of private equity firms, typically organized as partnerships, has attracted widespread attention because of their favorable compensation arrangements and the seeming porousness of the publicly traded boundary. The so-called "Blackstone bill" would classify as a corporation any publicly traded partnership that derives income from asset management or investment advisory services.<sup>22</sup> The proposed legislation is a rifle-shot response to an aggressive planning technique, involving the use of "blocker corporations" interposed between an active business and a publicly traded entity to convert "bad" (nonqualifying) income into "good" (qualifying) income for purposes of the passive income exception under § 7704.<sup>23</sup> While this use of blockers was viewed as undermining the existing

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declined from 17% to 6%. See also MARK P. KEIGHTLEY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM 7-8 (2012).

17. See, e.g., I.R.C. § 1361(b)(1)(A) (100 shareholder limit), (b)(3) (qualified Subchapter S subsidiary), (c)(1) (family members treated as a single shareholder), and (c)(6) (certain tax-exempt organizations).

18. S shareholders are required to include "reasonable compensation" in their FICA tax base but are not subject to self-employment tax. See David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012); Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749, 807 (2009) (suggesting that avoiding payroll tax "is a primary, perhaps *the*, primary force behind the use of S corporations").

19. See I.R.C. § 1402(a)(13). The limited-partner exclusion is outmoded because state law generally no longer prevents limited partners from actively participating in the partnership's business. See J. COMM. ON TAX'N, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 97-99 (2005).

20. See I.R.C. § 1402(a)(1), (2), (3), (10).

21. See Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137 (2011) (LLP partners not treated as limited partners). In 1997, Treasury proposed regulations that attempt to distinguish between active and inactive passthrough participants, but Congress imposed a moratorium on enforcement of the regulations. See Prop. Treas. Reg. § 1.1402-2(a) (1997).

22. See e.g., J. COMM. ON TAX'N, JCX-62-07, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I 49-50 (2007).

23. See Taylor, *supra* note 12, at 1 (describing a blocker (or stopper) as an entity whose

publicly traded line, the larger issue is whether the line itself is properly drawn.<sup>24</sup>

Even though the passthrough sector includes many “small” businesses, large partnerships and S corporations account for a substantial portion of total assets and total receipts. In 2009, partnerships with \$100 million or more in assets constituted only 0.6% of all partnerships but held 72% of all partnership assets; S corporations with \$100 million or more in assets constituted only 0.08% of all S corporations but held 36% of all S corporation assets.<sup>25</sup> Total receipts are also disproportionately concentrated in a small number of large partnerships and S corporations. While approximately 0.2% of partnerships reported gross receipts in excess of \$50 million in 2009, they accounted for 67% of total partnership receipts; the 0.3% of S corporations with total receipts in excess of \$50 million accounted for 35% of total S corporation receipts.<sup>26</sup> By any standard, the upper echelons of partnerships and S corporations comprise very large firms. Yet such entities escape the two-level corporate tax.<sup>27</sup>

Passthrough income is disproportionately concentrated among high-income individuals. In 2006, taxpayers with adjusted gross income above \$250,000 received 62% of all passthrough income.<sup>28</sup> If taxes rise on net passthrough income, high-income individuals would bear the brunt of the tax increase. Assuming corporate tax cuts are financed by allowing the top two individual rate brackets to revert to pre-2001 levels, the increase in the individual tax rate is estimated to affect only about 3% of small businesses.<sup>29</sup>

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insertion into a structure is intended to change the underlying character of the income (or assets) or otherwise achieve a tax result that would be unavailable without the use of multiple entities); *see also id.* (suggesting that use of the entity classification rules for this purpose may be immune from challenge under the economic substance doctrine).

24. *See* DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 142 (2009); *id.* at 143 (noting that “future companies may not need public tradability if mechanisms emerge to create investor liquidity without it”).

25. *See* J. COMM. ON TAX’N, JCX-66-12, *SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITIES* 11 (2012).

26. *See id.* at 11–12.

27. *See* Martin A. Sullivan, *Why Not Tax Large Passthroughs as Corporations*, 131 *TAX NOTES* 1015, 1017 (2011) [hereinafter Sullivan, *Why Not Tax Large Passthroughs*] (criticizing the lack of a level playing field).

28. *See* MARK P. KEIGHTLEY, *CONG. RESEARCH SERV.*, R43259, *WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA* 3 (2012) [hereinafter Keightley, *ANALYSIS OF INDIVIDUAL TAX RETURN DATA*].

29. *See* JANE G. GRAVELLE, *CONG. RESEARCH SERV.*, R41392, *SMALL BUSINESS AND THE EXPIRATION OF THE 2001 TAX RATE REDUCTIONS: ECONOMIC ISSUES* 6 (2010). The American Taxpayer Relief Act of 2012 effectively repeals the top two brackets but only for roughly the upper 1% of taxpayers. Pub. L. No. 112-240, § 102(b)(1), 126 Stat. 2313 (2013) [hereinafter ATRA].

A large portion of all passthrough income would be affected, however, because ownership of large passthroughs is concentrated among high-bracket individuals.<sup>30</sup> If corporate tax cuts are financed by reducing business tax preferences, passthroughs would be adversely affected, since most tax preference items used by corporations are also used extensively by passthroughs.<sup>31</sup> Although the bulk of income earned by partnerships and S corporations is active income, these entities also report significant amounts of passive income—25% of total income for partnerships and 10% for S corporations, respectively.<sup>32</sup> Beginning in 2013, such income is potentially subject to the 3.8% Medicare tax on unearned income.<sup>33</sup> Passthroughs also account for a surprisingly high percentage of net long-term capital gains; between 1997 and 2007, the percentage of such gains attributable to passthroughs increased from 30.1% to 44.4%.<sup>34</sup> Passthrough owners thus stand to lose significantly if the capital gain rate is increased.<sup>35</sup>

While lower corporate tax rates appeal to business managers,<sup>36</sup> corporate-shareholder integration has little political support. In 2003, the Bush administration initially proposed a version of the 1992 Treasury integration proposals that would have permitted exclusion of dividends at the shareholder level, but only if such dividends were paid from previously taxed corporate income.<sup>37</sup> Instead, Congress enacted a 15% rate for qualified dividend income regardless of whether such amounts were previously taxed at the corporate level.<sup>38</sup> Simultaneously, in the guise of providing additional shareholder level relief, Congress reduced the rate on

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(modifying § 1(h)(1)(C) (15% rate) and adding new § 1(h)(1)(D) (20% rate)).

30. See Martin A. Sullivan, *Should We Raise Tax Rates on Wealthy Employers?*, 132 TAX NOTES 979, 980 (2011).

31. See *Small Businesses and Tax Reform: Hearing Before Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 112th Cong. 7 (2011) (statement of Robert Carroll) [hereinafter *Statement of Robert Carroll*] (indicating that, between 2011 and 2015, passthroughs account for 22% of projected annual business tax expenditures totaling roughly \$100 billion).

32. See Keightley, ANALYSIS OF INDIVIDUAL TAX RETURN DATA, *supra* note 28, at 6.

33. See I.R.C. § 1411.

34. See *Tax Reform and the Tax Treatment of Capital Gains: Hearing Before the H. Comm. on Ways & Means and the S. Comm. on Fin.*, 112th Cong. 4 (2012) (statement of Leonard E. Burman). The growth of private equity funds and other investment partnerships may help to explain this shift.

35. If the 2003 tax cuts had been allowed to expire, the rates for capital gains and dividends would have increased to 23.8% and 43.4%, respectively. Instead, the ATRA maintains the 15% rate on capital gains and dividends for all but the highest earners, who now face a 23.8% rate. See *supra* note 29.

36. See Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Tax Rates*, 126 TAX NOTES 641, 646 (2010). European countries have also moved away from integration, while significantly lowering corporate tax rates and broadening the corporate tax base. *Id.*

37. See generally Karen C. Burke, *Is the Corporate Tax System “Broken”?*, 28 VA. TAX REV. 341, 347–53 (2008); Michael Doran, *Managers, Shareholders and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009).

38. Burke, *supra* note 37, at 350.

capital gains regardless of whether such gains were derived from retained earnings.<sup>39</sup> Thus, Congress created an unstable situation in which a temporary dividend tax cut potentially encouraged dividend payouts in anticipation of a future increase in the dividend tax rate.<sup>40</sup> Reducing corporate tax rates would undermine the rationale for the 2003 tax cuts as a way of mitigating the double level tax burden on corporate earnings. By contrast, increasing the rate on dividends and capital gains could help to finance lower corporate rates and improve progressivity.<sup>41</sup>

### III. SHELTERING WITHIN CORPORATIONS

If corporate tax rates fall and individual tax rates rise, C corporations could again become attractive as tax shelters, reversing the “disincorporation” phenomenon that followed the 1986 Act. While such a “reincorporation” strategy may appear counterintuitive, its attractiveness would depend on the disparity between the maximum individual and corporate tax rates and the ability to defer (or avoid) the shareholder level tax on distributed corporate income.<sup>42</sup> Reducing the combined corporate-shareholder tax burden could also impair the overall level of progressivity.<sup>43</sup> Increasing taxes on net passthrough income could have the opposite effect, since such income is concentrated among high-bracket individuals and the tax burden may not be easily shifted. Nevertheless, passthrough owners can be expected to press to keep rates low for noncorporate net business income, while resisting any effort to shift the cost of corporate tax reform to the passthrough sector.

While it might be possible, in theory, to limit corporate rate reductions to publicly traded entities for which concerns about international competitiveness are most plausible, such an outcome seems politically

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39. *Id.*

40. See Stephen A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 573. Although the ATRA averted decoupling of the tax rates for dividends and capital gains, it remains to be seen how stable the compromise will prove. See *supra* note 35.

41. See generally Rosanne Altshuler et al., *Capital Income Taxation and Progressivity in a Global Economy*, TAX POL'Y CENTER, May 12, 2010 (arguing that restoring the pre-1997 rates on capital gains and dividends would enhance progressivity and permit a reduction in the corporate tax rate from 35% to 26%).

42. Passthrough taxation would remain attractive to allow losses and tax-preferred income to pass through.

43. See Gravelle & Hungerford, *supra* note 14, at 428–33 (discussing recent empirical work on the incidence of the corporate tax). See generally JANE G. GRAVELLE & THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., RL34229, CORPORATE TAX REFORM: ISSUES FOR CONGRESS (2012).



unrealistic. A more likely outcome would be reduced tax rates for all C corporations, including closely held corporations. Permitting closely held corporations to benefit from reduced rates would greatly magnify the tax shelter problem. Under current law, there is generally no reason for a new business to elect corporate form except to exploit the low rate brackets for the first \$75,000 of corporate income.<sup>44</sup> If corporate rates are significantly reduced, eliminating the low rate brackets should be given serious attention.<sup>45</sup> Graduated rates are not needed to provide a special benefit to small businesses, which can elect Subchapter S status or be taxed as a partnership by default. Moreover, many small businesses may be owned by high-income individuals who would otherwise be taxed at the maximum individual rate. A more far-reaching proposal would be to limit Subchapter C to publicly traded corporations and their subsidiaries, reducing the need for anti-abuse provisions.<sup>46</sup>

If corporate tax rates are cut, the preferential rate should not be extended to business income generally.<sup>47</sup> The justification for preferential treatment of all business income is that the corporate tax functions essentially as a tax on capital income, and hence lower rates should logically apply to noncorporate net business income as well.<sup>48</sup> The drive to reduce corporate tax rates, however, is based on the need to improve international competitiveness, not the desirability of reducing taxes on capital income generally. Nevertheless, corporate tax reform may falter politically because of well-organized opposition from the passthrough sector. The main concern is that the passthrough sector would be harmed by eliminating tax preferences to finance corporate tax reform, since passthroughs would lose the preferences but would not benefit from the lower corporate rate.<sup>49</sup>

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44. See I.R.C. § 11(b).

45. See generally Steven A. Bank, *Taxing Bigness*, TAX L. REV (forthcoming 2013) (tracing the history of the graduated corporate tax rate); Jeffrey L. Kwall, *The Repeal of Graduated Corporate Tax Rates*, 131 TAX NOTES 1395 (2011); cf. John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX L. REV. 885, 978 (2000) ("In fact, lobbyists for small private C corporations fight fiercely and effectively for the preservation and expansion of the inside shelter from lower graduated rates . . .").

46. See George K. Yin, *Corporate Tax Reform, Finally, After 100 Years*, in TOWARD TAX REFORM: RECOMMENDATIONS FOR PRESIDENT OBAMA'S TASK FORCE 114, 115 (Tax Analysts ed. 2009).

47. Cf. U.S. DEP'T OF THE TREAS., OFFICE OF TAX POLICY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 50–51 (2007) (proposing carving out business income of passthrough entities for a "special reduced business tax rate as part of the individual income tax"; the special rate would be set equal to the maximum corporate rate).

48. See Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L. & SOC. POL'Y 41, 42 (2010).

49. See *Statement of Robert Carroll*, supra note 31, at 7 (warning of the "potential for undesirable side effects"); MARTIN A. SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN

Enthusiasm for cutting corporate tax rates may well splinter over the issue of which (if any) preferences should be reduced or eliminated.<sup>50</sup>

Even if corporate tax rates are cut, corporate earnings would still be subject to a shareholder level tax when distributed. Taxing distributions could help to minimize revenue losses from lower corporate rates and prevent erosion of the individual income tax base. For example, assume that the maximum individual rate is increased to 40%, the maximum corporate rate is reduced to 25%, and a “distribution tax” of 20% is levied on all corporate distributions to individual shareholders. If a corporation earns \$100 and pays \$25 tax, a distribution of the after-tax amount (\$75) would attract a distribution tax of \$15 at the shareholder level, yielding a combined corporate-shareholder tax burden of 40% equal to the maximum individual rate.<sup>51</sup> The combination of the two taxes yields the same aggregate burden as taxing income only once at the shareholder’s rate. The “split-rate” approach is attractive because it could accommodate a range of corporate and distribution tax rates.<sup>52</sup> The lower the corporate tax rate, however, the higher the distribution tax rate that would be needed to achieve the desired combined tax burden.<sup>53</sup> As a practical matter, a high distribution tax rate (and low corporate tax rate) would greatly exacerbate tax planning aimed at deferring or avoiding the second level of tax, while enhancing the benefit of reinvesting retained earnings within the corporation.

To ensure a uniform tax burden on distributed corporate earnings, capital gains and dividends should be taxed at the same rate. If the capital

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THE 21ST CENTURY 109 (2011) (“One of the most difficult political hurdles for corporate tax reform is its potentially negative effect on pass-through businesses.”).

50. See Jane G. Gravelle, *Practical Tax Reform for a More Efficient Income Tax*, 30 VA. TAX REV. 389, 402–03 (2010) (even eliminating nearly all business tax expenditures would only allow the corporate tax rate to be reduced by a few percentage points); Heather M. Rothman, *As Details Emerge, Business Community Could Split on Tax Reform, Practitioner Says*, 172 DAILY TAX REP., Sept. 6, 2012, at G-2.

51. The shareholder would be left with \$60, the same amount that would be available after tax if passthrough income of \$100 were taxed at a 40% rate. To equate the burden on distributed corporate income and passthrough income, the distribution rate (d) would need to be set equal to  $(p-c)/(1-c)$  where p is the shareholder’s marginal tax bracket and c is the corporate tax. See Halperin, *supra* note 36, at 645 n.23.

52. For example, it would be possible to maintain roughly the pre-2013 burden on distributed corporate earnings (44.75%) by setting the corporate and distribution tax rate both at 25%. See *id.* at 644 n.16. The shareholder would owe a tax of \$18.75 on \$75 distribution (\$100–\$125 corporate tax), resulting in a combined burden of 43.75%. Under the ATRA, the combined burden is roughly 50.5%, assuming dividends are taxed at 23.8%. See *supra* note 29.

53. To maintain a 44.75% combined corporate-shareholder burden, a 15% corporate tax rate would require a distribution tax rate of 35%. The shareholder would owe a tax of \$29.75 on the \$85 distribution (\$100–\$115 corporate tax), resulting in a combined burden of 44.75%.

gain rate is lower than the dividend rate, shareholders have an incentive to withdraw earnings in nondividend transactions. Given the current parity of the capital gain and dividend rates, the distinction between dividend and nondividend distributions often matters only for purposes of basis recovery. If the rate parity proves permanent, it may be possible to eliminate provisions designed to police the boundary between dividend and nondividend distributions.<sup>54</sup> Basis recovery continues to be important, however, if a shareholder has a high basis. If stock is held until death, the § 1014 basis step-up affords an easy escape from the distribution tax with respect to a shareholder's share of undistributed corporate earnings and unrealized appreciation in corporate assets.<sup>55</sup> Taxing distributions uniformly would require reducing the death time basis step-up and denying the full charitable deduction for contributions of appreciated corporate stock.<sup>56</sup> Such reforms may be politically unrealistic, however, and would reintroduce the vexing problem of allocating income under a passthrough model.

Taxing distributions would not eliminate the fundamental problem of sheltering within the corporation—namely, the ability to retain earnings and achieve a higher after-tax return on the reinvested earnings whenever the corporate rate is lower than the individual rate.<sup>57</sup> Immediate distribution of corporate earnings accelerates the shareholder level tax, while retention defers the tax. If investments inside the corporation earn the same after-tax return as investments outside the corporation, however, there is generally no advantage to deferral of the tax.<sup>58</sup> Deferring distributions is advantageous, however, if the return on retained corporate earnings is taxed at a lower rate than the return on amounts invested outside the corporation. While there is no advantage to deferring the distribution tax on the initial corporate earnings, the ability to earn a higher after-tax return on retained corporate earnings represents a permanent benefit that increases the longer amounts remain invested within the corporation.<sup>59</sup> In the extreme case, if the corporate rate were set to zero, all corporations would essentially function as “special tax-free savings accounts.”<sup>60</sup> Reinvested corporate earnings would grow tax-free and the accumulated return would be reduced only by the distribution tax.

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54. See, e.g., I.R.C. § 302(b) (redemptions treated as exchanges).

55. I.R.C. § 1014.

56. See Halperin, *supra* note 36, at 654.

57. See *id.* at 646.

58. The cost of an immediate dividend distribution is equal to the discounted present value of the tax that would otherwise be due if earnings were retained and distributed as a dividend in the future. See generally Daniel Halperin, 2009 Erwin N. Griswold Lecture Before the American College of Tax Counsel: *Rethinking the Advantage of Tax Deferral*, 62 TAX LAW 535 (2009).

59. See Halperin, *supra* note 36, at 647–48.

60. SHAVIRO, *supra* note 24, at xiii.

Under passthrough treatment, undistributed net business income would be taxed currently at the owner's tax rate. If the same business were incorporated, the profits and any accumulated earnings would be taxed currently only at the lower corporate rate, subject to a potential future distribution tax. As under pre-1986 law, high-income individuals would have a strong incentive to use corporations as tax shelters, exploiting higher corporate after-tax returns while deferring the distribution tax. Corporations could once again serve as incorporated pocketbooks for passive investments, heightening the significance of corporate "penalty" taxes.<sup>61</sup>

Lower corporate tax rates would also encourage shareholder-owners to disguise compensation as dividends. In the case of C corporations, the concept of "reasonable compensation" has focused mainly on the potential for excessive compensation.<sup>62</sup> By contrast, undercompensation is apparently rampant in S corporations where owners have an incentive to avoid employment taxes by paying themselves minimal compensation and passing through the S corporation's residual earnings as noncompensation income.<sup>63</sup> Significant revenue could be raised by extending the compensation rules for general partners to all members of passthrough entities—including LLCs, LLPs, and S corporations—who materially participate in the business.<sup>64</sup> Treating all active passthrough owners alike for compensation purposes would curtail the use of S corporations to reduce employment taxes.

If corporate tax rates are reduced, it would also be desirable to harmonize the employment tax treatment of shareholders of S corporations and privately held C corporations.<sup>65</sup> In the close corporation context,

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61. See I.R.C. §§ 531–37 (accumulated earnings tax), §§ 541–47 (personal holding company tax). A more radical approach would be to tax all passive income earned through corporations at the maximum individual rate, though this approach could be viewed as penalizing investment in corporate form. See Halperin, *supra* note 36, at 653.

62. Under current law, personal service corporations are already taxed at the maximum individual rate. See I.R.C. §§ 448(d)(2), 11(b)(2).

63. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009) (estimating that, in 2003 and 2004, S shareholders underreported compensation by roughly \$23.6 billion).

64. See PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 67 (2010). Certain types of income, such as interest and rental income, would continue to be excluded from self-employment income. *Cf.* Schwidetzky, *supra* note 18, at 793–94 (arguing that the material participation standard is overly broad as applied to nonservice partnerships).

65. See Richard Winchester, *The Gap in the Employment Tax Gap*, 20 STAN. L. & POL'Y REV. 127, 149–50 (2009). The number of owners dramatically affects the incentive to mischaracterize labor income as capital income. See CONG. BUDGET OFFICE, Pub. No. 4168, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX 14 (2012); see also Nicholas Bull & Paul Burnham, *Taxation of Capital and Labor: The Diverse Landscape by Entity Type*, 61 NAT'L

disguising salary as dividends avoids payroll taxes and defers shareholder level tax until such amounts are distributed. Reducing corporate tax rates significantly below the maximum individual rate would clearly exacerbate the failure of existing law to adequately police mistaxation of labor income. Using corporations to shelter labor income would not only reduce the individual income tax base but also erode the long-term solvency of the Social Security and Medicare trust funds.<sup>66</sup>

#### IV. PUBLICLY TRADED PARTNERSHIPS AND ENTITY CLASSIFICATION

If integration of corporate-shareholder taxes is impractical or unattainable, mitigating the disparity between large passthroughs and corporations may be worth exploring. Consistent with this goal, policymakers have expressed interest in taxing large passthroughs as corporations.<sup>67</sup> These proposals reflect concern over the long-term decline in corporate tax revenues and the related rise of the passthrough sector.<sup>68</sup> The difference in tax treatment of otherwise identical firms based solely on their legal structure may also be perceived as inequitable. Taxing large passthroughs as corporations could help to finance lower tax rates by broadening the corporate tax base.<sup>69</sup> In turn, lower rates would mitigate the existing distortions under the two-level corporate tax. The continued expansion of publicly traded partnerships and the growth of private equity suggest a need to rethink the public-trading line that demarcates corporate and noncorporate entities.<sup>70</sup>

Critics claim that the large partnership proposal would reverse a consistent trend toward liberalizing access to passthrough taxation and

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TAX J. 397, 400–01 (2008); *id.* at 418 (estimating that the gap in reported labor income of business owners, not including C corporations with more than 75 shareholders, was \$153.4 billion in 2002).

66. Cf. Willard B. Taylor, *Payroll Taxes—Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983, 996 (2012) (recommending integration of payroll taxes and individual taxes).

67. See FRAMEWORK, *supra* note 1, at 10 (suggesting the need for “greater parity” in the treatment of large corporate and noncorporate entities).

68. While corporate taxes accounted for nearly 30% of total federal taxes in 1953, they fell to less than 9% of total federal taxes in 2010. See KEIGHTLEY & SHERLOCK, *supra* note 16, at 11; Jane G. Gravelle, *The Corporate Tax: Where Has It Been and Where Is It Going?*, 57 NAT’L TAX J. 903, 903–04 (2004); see also CBO, TAXING BUSINESSES, *supra* note 2, at 15–19 (discussing implications of shift to passthroughs on federal tax revenues); Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by \$140 Billion*, 130 TAX NOTES 987 (2011).

69. Although the number of passthrough entities affected would likely be small, the proposal could potentially raise significant revenue because of the size of the affected firms. See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42451, TAXING LARGE PASS-THROUGHS AS CORPORATIONS: HOW MANY FIRMS WOULD BE AFFECTED? 2 (2012).

70. See *Hearing Before S. Fin. Comm. on the Taxation of Business Entities*, 112th Cong. (2012) (statement of Alvin C. Warren). Of the nearly 100 publicly traded partnerships, most are concentrated in investment banking and energy-related industries. See Sullivan, *Why Not Tax Large Passthroughs*, *supra* note 27, at 1016.

would move further away from the integration ideal.<sup>71</sup> These objections may miss the mark, however. Expansion of passthrough taxation is attributable largely to self-help integration, the rise of limited-liability entities, and lobbying on behalf of S corporations and other passthrough entities. The enthusiasm for passthroughs also ignores notorious tax shelters—such as *ACM*, *Castle Harbour*, and Son-of-BOSS transactions—that manipulated the partnership rules to drain revenue from the corporate and individual tax bases.<sup>72</sup> Although Congress has repeatedly sought to reform Subchapter K, well-meaning attempts to target particular abuses have often added complexity without deterring tax-motivated transactions. Moreover, limiting the choice to double-level taxation or passthrough taxation poses a false dichotomy and ignores the realistic alternative of a single tax imposed exclusively at the entity level.<sup>73</sup>

In the wake of the 1986 Act, exempting certain publicly traded partnerships from § 7704 might have seemed reasonable, given the perceived shortcomings of the two-level tax system. If the alternative is a single tax imposed at the entity level, however, it is not clear that passthrough treatment continues to be warranted. An entity level tax offers a more efficient and administrable approach that could improve compliance; taxes would be collected from a limited number of entities rather than from a much larger number of individual taxpayers. In the late 1990s, the ALI project on classification and streamlining of private business organizations considered but ultimately rejected an entity level approach, while acknowledging that the “choice between conduit and entity taxation is a very close one.”<sup>74</sup> Other commentators have concluded that complex private business enterprises should be subject to a single entity level tax when income is earned.<sup>75</sup> These proposals were all premised on the notion that the

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71. See Philip F. Postlewaite, *Raising Revenue Through Misguided Classification Reform*, 136 TAX NOTES 1177, 1180, 1187 (2012).

72. *ACM Partnership v. Comm’r*, 157 F.3d 231 (3d Cir. 1998); *TIFD III–E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012) (“*Castle Harbour*”). See generally Karen C. Burke & Grayson M. P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 TAX LAW. 59, 64 (2008).

73. See George K. Yin, *Publicly Traded Partnerships, Closely Held Corporations and Entity Classification for Tax Purposes*, 88 TAXES 329, 329 (2010).

74. George K. Yin & David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises*, in 3 J. COMM. ON TAX’N, JCS-3-01, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION 220, 229 (2001).

75. See generally Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1998); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999).

task of ascertaining the partners' economic arrangement under Subchapter K in its current form is excessively burdensome.

Subchapter K was never intended to accommodate interests that are widely held and frequently traded. While Congress in 1997 enacted simplified reporting rules and a special audit regime for "electing large partnerships" with more than 100 partners, few partnerships make the election.<sup>76</sup> Under current proposals, the large partnership audit rules would be mandatory for partnerships with more than 1,000 partners, but the simplified reporting rules would remain elective.<sup>77</sup> Although the mandatory large partnership audit rules might mitigate existing inefficiencies, they would probably do little to overcome the perception that IRS auditors are often reluctant to audit partnerships and are limited in their ability to identify relevant technical issues.

Very few widely held partnerships comply fully with the requirements of Subchapter K.<sup>78</sup> Often these partnerships ignore technical compliance and resort to creative tax allocations to ensure fungibility of interests. Some commentators assert that technical noncompliance does not necessarily pose a problem for the tax system, reasoning that the managers of widely held partnerships are seldom familiar with the tax profiles of particular investors and hence have little incentive to engage in strategic tax allocations to take advantage of disparities in tax characteristics.<sup>79</sup> Unfortunately, such self-serving claims are unverifiable because these entities routinely escape audit.<sup>80</sup> More importantly, there are grounds for concern that certain types of partnerships operate under special rules outside the normal framework of Subchapter K.

For example, securities partnerships are permitted to take advantage of special aggregation rules to comply with the requirements of § 704(c) with respect to allocations of built-in gain or loss.<sup>81</sup> The exception to the § 704(c) rules is justified on the theory that, given the need for frequent revaluations and the large number of assets involved, asset-by-asset allocation would be unduly burdensome. Recent tax bar proposals would expand the class of securities partnerships eligible to use special aggregation methods.<sup>82</sup> In

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76. See I.R.C. § 775(a)(1); Eric B. Sloan & Matthew W. Lay, *Beyond the Master Limited Partnership: A Comprehensive Review of Publicly Traded Partnerships*, 88 TAXES 229, 295 (2010).

77. See J. COMM. ON TAX'N, JCS-2-12, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSAL 622 (2012).

78. See Yin, *supra* note 73, at 330–31.

79. See *id.* at 331, 334 n.25.

80. See Amy S. Elliott, *Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS*, 136 TAX NOTES 351 (2012).

81. See Treas. Reg. § 1.704-3(e)(3) (2012).

82. See generally NYSBA TAX SECTION, AGGREGATION ISSUES FACING SECURITIES PARTNERSHIPS UNDER SUBCHAPTER K (2010).



addition, such partnerships would be permitted to adjust basis under §§ 734(b) and 743(b) on an aggregate (rather than asset-by-asset) basis following certain distributions and transfers of interests.<sup>83</sup> Like the special aggregation rules for § 704(c), the exception to the basis adjustment rules is defended on the ground that compliance would be unduly burdensome.<sup>84</sup>

Under current law, securities partnerships routinely employ so-called “stuffing allocations” to circumvent the basis adjustment rules. Stuffing allocations (also referred to as “fill-up” or “fill-down” allocations) specially allocate taxable gain or loss to a withdrawing partner equal to that partner’s share of unrealized gain or loss in the partnership’s assets.<sup>85</sup> The special allocation does not change the amount of gain (or loss) recognized by the withdrawing partner but may change the character of such gain (or loss).<sup>86</sup> By shifting taxable gain away from the other partners, the special allocation effectively allows them to deduct a portion of the purchase price of the redeemed partner’s interest. If challenged, it seems highly unlikely that such allocations would be respected as satisfying the substantial economic effect test under the § 704(b) regulations. Rather than sanctioning a de facto two-track partnership regime to facilitate fungibility of actively traded partnership interests, it may be worthwhile to consider imposing an entity level tax on publicly traded partnerships and certain securities partnerships.

## V. CONCLUSION

The 1986 Act reforms were politically feasible largely because they shifted a substantial portion of the individual tax burden to the corporate sector. In contrast, current proposals for reducing corporate tax rates would in effect shift a portion of the corporate tax burden back to individuals. While simply lowering the corporate tax would clearly be regressive, such a reform could enhance overall progressivity if coupled with higher tax rates on dividends and capital gains. A combined corporate-shareholder tax burden at least equal to the maximum individual rate would be essential to prevent corporations from reemerging as tax shelters and thereby eroding the personal income tax base. As a result of self-help integration and the

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83. *See id.* at 16.

84. *See id.* at 28.

85. *See id.* at 35–36. Because the stuffing allocation equalizes the distributee’s outside basis and the amount of cash distributed, the distribution does not trigger gain recognition under § 731(a); as result, no basis adjustment is required under § 734(b).

86. *See* David S. Miller & Jean Bertrand, *Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers*, 65 TAX LAW. 309, 334 (2012).



proliferation of passthrough entities—each with its own powerful business constituency—the corporate tax has become essentially a tax on public trading. Comprehensive reform should reconsider the boundaries between public and private business firms as well as the feasibility of a single entity level tax for entities that cannot easily comply with a passthrough regime.