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Master Limited Partnerships: Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, One Hundredth Congress, First Session

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MASTER LIMITED PARTNERSHIPS

TUESDAY, JUNE 30, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]
Chairman Rangel. We’ll be opening up the hearings, and I apologize for being late.

Today our subcommittee will continue its series of hearings to study the treatment of various pass-through entities established under our tax laws. On June 9, 1986, we held the first series which was designed to provide a broad overview of tax policy issues affecting pass-through entities, and today and tomorrow we continue to focus on the issue of master limited partnerships.

The issue of the proper treatment of the so-called MLPs is one which presents the subcommittee with several policy, revenue and technical concerns. From a policy standpoint the tax laws have treated businesses conducted as partnerships differently from those conducted as corporations. Whether the master limited partnership form blurs the distinction between partnership or corporate forms and whether the MLPs form conform with sound tax policy are serious questions that we will be considering today and tomorrow.

With respect to the revenue concerns, the staff of the Joint Committee on Taxation has not provided us yet with an estimate of the impact of the master limited partnership activities or on anticipated corporate revenue receipts. We will be very interested in testimony from today’s and tomorrow’s witnesses which will assist the subcommittee and the staff in determining the revenue impact of this form of business activity. We will look forward to receiving testimony regarding technical and compliance issues relevant to the proper treatment of the master limited partnership. The problems involved in record keeping and the ability to insure proper compliance are of great interest to this committee.

In addition we expect to receive testimony regarding the question of whether certain technical requirements and elections contained in the partnership rules can be properly applied with respect to the master limited partnership.

We look forward to an in-depth analysis of these issues today and tomorrow. In order to facilitate our consideration to allow us sufficient time to question witnesses, I would ask that the witnesses, with the exception of the Treasury, to summarize their testimony in a five minute period with the assurances that their entire printed testimony will appear in the record. And I will ask our clerk to make certain that the proper electronic signals are given so that it would advise the witnesses of the remaining time.

I ask that the press release announcing today’s hearings be made a part of the record.

Chairman Rangel. And now it is my distinct pleasure to welcome a fellow New Yorker and a distinguished member of the administration, the Honorable J. Roger Mentz, Assistant Secretary for Tax Policy of the Department of the Treasury.

And before I proceed, I would ask whether or not any member wishes to make an opening statement.

Mr. McGrath?

Mr. McGrath. Thank you, Mr. Chairman.

I have received an inordinate amount of concern regarding this hearing, and I think as we see the crowd assembled in the hearing room today, we can understand——

Chairman Rangel. It’s not welfare reform.
Mr. McGrath. This is right—that there are some interesting issues that lie before us here.

I was interested in your comments in your opening statement that the Joint Committee has yet to give us revenue estimates or tell us whether there are any revenue increases in this at all. And if it is your opinion that there may not be any revenues in this, then I suggest we adjourn.

Thank you, Mr. Chairman.

Chairman Rangel. Mr. Andrews?

Mr. Andrews. Thank you, Mr. Chairman.

I am delighted, Mr. Chairman, that this is not welfare reform we are discussing this morning.

I think it is appropriate that our committee examine this issue very, very carefully. I think it is something that the staff and all of us should look at over the coming months. I think it is important, however, as we examine the witnesses and study the documents that we recognize that the tax reform bill was really enacted only a few short months ago. Many provisions that became effective in January 1987 are still working their way through the marketplace. If we are to examine adequately the impact of the tax bill, I think we need more time to do so.

One of the things I hear from my constituents is to leave the code alone; let the marketplace work its will to see what the long-range and short-range effects and consequences of this tax bill will mean to the marketplace.

As we are aware, master limited partnerships are a rather new form of pass-through entity. The first MLP was formed in the early 1980's. There are several different kinds of MLPs that we will talk about today: rollouts, rollups, liquidations.

I think it is important that we ask why did these corporations set up MLPs in the first place. Was it for tax avoidance? Or were there other reasons just even more significant?

I know that the energy companies in most of the producing states, for example, use MLPs to raise capital for energy exploration and drilling. Many of them would literally have ground to a standstill without this important vehicle. At a time when the industry is already depressed and imports are on the rise, we need to assess the long-range impact any action we take may have on oil and gas exploration and development.

In addition, the real estate industry has traditionally used the partnership form to raise capital. This industry is also depressed not only in Texas but nationwide as a result of market factors coupled with the retroactive treatment of real estate activities under the passive loss rules.

I recognize that there is concern about the so-called disincorporation of America. And I know Mr. Mentz will address this particular issue.

We should examine also though how all corporations raise investment capital today and whether the investment income is subject to single or double taxation. I urge the committee to examine what is really going on in the marketplace as a result of the 1986 tax changes and caution against any further changes that might add to the crippling of the oil and gas and real estate industries in this country.
Mr. Chairman, I look forward to the hearings this week.
Chairman Rangel. Are there any further statements?
Mr. Gregg. Mr. Chairman, I would like to echo the concerns raised by my colleagues from Texas and New York. Not coming from either of those States which have a much more intimate involvement with the operative aspects of MLPs, I, however, do have genuine concern. And my concern is that no matter what we do in this area, I don’t think we’re going to impact only the master limited partnerships. We are going to impact all limited partnerships if we attempt to go down a legislative road.

And as a small town tax practitioner, I always found it exceptionally frustrating that the Treasury Department never did issue regulations or rather only for 48 hours issued regulations on trying to define this area. And it was always very difficult to practice in this area because of the Treasury Department’s sort of ax that they held over our heads by not adequately outlining what was and wasn’t a partnership.

But if we are going to move into this area, I think we have to acknowledge that we are going to impact all forms of partnerships not just master limited partnerships. The scope of this hearing or any legislation in this area is much broader than just these unique vehicles because any legislation I suspect is not going to be able to be drafted narrowly enough to just impact those vehicles.

Second, I fought very hard in opposition to the repeal of the General Utilities doctrine when we were marking up the tax bill in 1986. I think it was a major mistake to repeal that doctrine. I don’t think that we should start penalizing corporations which are trying to plan effectively in light of that repeal and trying to do what the General Utilities doctrine allowed people to do prior to the 1986 law because I personally feel that that was an appropriate approach anyway. And so, I think one of the things that is causing momentum in this area is an improper consideration, and that’s the fact that people are trying to get around the repeal of the General Utilities doctrine.

Third, it seems to me that as a very practical matter that anything we do in this area will be arbitrary, that whatever number we pick or whatever way we decide to define what partnerships are, it’s going to be an arbitrary decision. And if we’re going to make arbitrary decisions legislatively, I think that’s a mistake. I would rather have the marketplace drive those decisions than the regulatory effort.

Chairman Rangel. If there is no—Mr. Dorgan?
Mr. Dorgan. Well, Mr. Chairman, following up on those remarks, I think it is fair to say most of us don’t know the difference between an MLP and a four-bottom plow. This is a new area with consequences most of us don’t understand or probably recognize. I think that most of us are concerned about what is being proposed and what the impact of it would be. I think it is fair to say I don’t have any preconceived notions about what we ought to do, but I am concerned about what is being proposed and what impact it might have on general partnership taxation. I am interested in learning exactly what is happening out in the marketplace and what that might suggest for action or no action on behalf of this committee.

Chairman Rangel. I recognize the gentleman.
Mr. Brown. Thank you, Mr. Chairman.

I want to commend the chairman for bringing this matter before us, and following up on it. I think it is a vitally important area, one that deserves and merits our attention. And I want to commend the Treasury for taking a look at this area as well.

This particular discussion with regard to MLPs involves, I think, one of the most remarkable turnarounds in such a brief period of time that I have ever seen in the tax law. Less than a year ago, Treasury's position was that this would not have a significant impact; that is, for the first time in more than a half a century having the corporate rate being higher than the top personal rate would not lead to disincorporation, would not lead to a major loss of revenue in this area. If I understand the Treasury's current position, it is that it could well have a significant impact.

I think it is appropriate to look at this. The relative rates with regard to corporations and individuals I think will result in some changes. I was disappointed that that was not recognized when the tax bill dealt with it. I think it is appropriate to take a look at that area again.

I hope, as we look at it, we will try and make some sense out of the way we treat these trustee entities or nontaxable entities or partnerships, whether we call them MLPs or even look at a subchapter S. To focus only on free transferability I suspect gives us some problems with consistency. We obviously have transferability of ownership in a subchapter S along with the flowthrough concept. Hopefully we will not be about making up a myriad of special entities with special rules, but that the product of our work will be some consistent treatment of these flowthrough entities that makes it not only rational and reasonable for a practitioner to work in this area, but provides some equity in the way we treat individuals who choose to organize and conduct business.

Chairman Rangel. Mr. Mentz, is it sound tax policy and are we losing money?
Mrs. Kennelly. Thank you. We are going to reconvene the Subcommittee on Select Revenue Measures on the issue of master limited partnerships.

I welcome the next panel, James J. Wilson, president and chief executive officer of Interstate General Co., L.P., John Lee of the College of William and Mary, and Lewis Sandler of the National Apartment Association, also Mr. Jeff Rosenthal of the National Association of Realtors.

Thank you. We will proceed as we did this morning.

Mr. Wilson, if you will start, the other witnesses will testify and then we will have questions.

STATEMENT OF JAMES J. WILSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INTERSTATE GENERAL CO., L.P.

Mr. Wilson. I have handed in a prepared text and I will not bother you with reading from it.

Mrs. Kennelly. It will be put in the record, sir.

Mr. Wilson. My name is James J. Wilson. I am president and CEO of Interstate General Co. Our company is in the real estate development and building business.

I started the company 30 years ago. We operated during those 30 years in four areas of the real estate business: development, home building, apartment construction, and apartment management.

During those 30 years we operated as a partnership. Some of our entities were subchapter S corporations, and we were the sponsors of approximately 30 partnerships that raised money for low and moderate income housing.

Today the company owns approximately 8,000 apartment units for low and moderate income families, and is continuing in that line of business.

In 1983-84 it was clear that our company was going to be required to raise additional equity capital if we were to continue in our line of business. At that time, being a partnership, there was a great deal of research by our attorneys as to the problems of raising equity in a partnership. We deferred doing it because the appropriate congressional committees were investigating the very question that we are now here today to discuss, and that is the difference between a private partnership and a public partnership.

It had been the Treasury's position for many years that a public partnership is, in fact, a corporation and should be taxed as a corporation. Because of that cloud, there wasn't a lot of activity in selling public units in a partnership.

However, the Congress, in its wisdom, during a 2-year period did research and came to a conclusion which culminated in the recently enacted Tax Act that they should not tax public partnerships.

As a result, in February our company signed an underwriting agreement with a group of investment bankers and sold 20 percent of our units to public unit holders and raised approximately $20 million of equity capital which went into the enterprise and paid off our short-term bank debt.

The question that is being considered here today is basically whether the Congress, in the two years of deliberations concerning
partnerships, made a mistake in their deliberations or whether there are some new facts which would have changed their decision, had they known them.

I submit to you the following: The question of taxing partnerships was well researched and the conclusion was reached that the changes in the tax law which implemented the repeal of General Utilities, doctrine and addressed the question of passive income, and those two items would effectively prevent the so-called massive flow of monies away from the Treasury in the form of loss of tax revenue.

Now I will comment on one last issue, and that is the patently unfair position of the Treasury that because a partnership has public shareholders it should be taxed—a double tax, in effect—and I submit to you the following: If our company were to be subject to a double tax, I think the members of this committee would realize very simply that it would be in the best interest of the 80 percent holders, of which I am 60 percent, that it would not be a good judgment to keep the public shareholders.

So by the simple expedient of taking them out of the enterprise, we now go back to a singly taxed entity and, as a result, the Treasury is not going to get any additional income out of it. But what they have done is squeezed out the small public stockholder.

I would like to remind the committee that the last tax bill did have a provision to encourage John Q. Public to become owners of partnerships, because of the passive income provision, and we now are talking about a provision today that possibly could be adopted that would eliminate the only vehicle in which the small public investor could participate.

Thank you.

[The statement of Mr. Wilson follows:]

STATEMENT BY JAMES J. WILSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF INTERSTATE GENERAL CO., L.P.

My name is James J. Wilson. I am president and chief executive officer of Interstate General Co., L.P., (“Interstate General”).

Interstate General is a Delaware limited partnership organized on December 31, 1986. Approximately 20 percent of its outstanding units are held by the public and traded on the American Stock Exchange.

Interstate General engages in four related real estate activities: community development, home building, development and ownership of rental apartments, and management services. Interstate General is the developer of, and a leading home builder in, the planned community of St. Charles, Maryland. St Charles is located 23 miles southeast of Washington, D.C. and consists of 9,100-acre development. Interstate General manages and has general partner interests in 30 apartment projects with a total of approximately 7,000 rental units. The market Interstate General serves is primarily entry level housing and multifamily housing for low income and elderly families.

This subcommittee will hear from economists and tax theorists on the issue that it has before it today. I am an engineer by training and a businessman with over 30 years experience in real estate construction, development, and management. I wish to address the practical side of publicly traded partnerships and to relate to you what I consider to be a success story for the economy that is due, in part, to the availability of publicly traded partnerships as a vehicle for raising capital.

Interstate General’s predecessor companies were owned approximately 60 percent by me and my family and 40 percent by various employees, former employees, and parties who had acquired interests as a result of business relations with the companies or personal contracts with me. Prior to the formation of Interstate General, the businesses now conducted by Interstate General attracted equity capital in various ways.
Initially, the predecessor companies were involved in the construction of relatively well-defined projects such as a single apartment project, a shopping center, or a commercial building. Equity capital for these projects was generally raised through limited partner contributions, principally by wealthy individuals or family investment companies. Minimum capital contributions of over $200,000 were typical.

Notwithstanding the size of the individual contributions, the amount of equity raised was generally limited. Also, the equity was limited to a single project and was not available to be used for business opportunities as they became available from time to time.

In 1976, a predecessor company to Interstate General ("ISC") needed to raise capital to continue the development of St. Charles, a planned Department of Housing and Urban Development community. Again, the vehicle used to attract equity capital for the development was a limited partnership. The additional equity raised for the development was $3.5 million. This was not sufficient to withstand the inevitable downturns in the cyclical real estate development business. There was no ready means of increasing the equity base utilizing the closely held limited partnership. For these reasons, we were forced into a debt restructuring with the Department of Housing and Urban Development early in 1983. After the restructuring business conditions improved and ISC was able to repay its remaining loans to HUD and raise limited amounts of capital through joint ventures, principally with financial institutions.

Notwithstanding these sources of capital, our business judgment was that our operations were still overly exposed to cyclical business downturns and that the cost of equity capital raised through joint ventures was higher than that available through public capital markets. Possibilities for tapping public markets included utilizing a corporation to issue shares to the public or using a partnership and admitting the public as limited partners to the partnership.

We determined that potential investors would view an investment in our business as an investment in our assets and would want to be assured of a return as the value of these assets was realized. For this reason, we decided to proceed with a public offering of limited partnership units.

Throughout this time, we closely followed legislative developments regarding the taxation of publicly held partnerships. We concluded that Congress after substantial attention had determined that publicly held partnerships would be taxed as pass through vehicles. In reliance on this and the fact that such partnerships were clearly allowed under existing law, Interstate General was organized and its units issued to the public at a price of $9 a unit. Two million, two hundred thousand units were sold to primarily non-institutional unitholders. We now have public investors who have invested a total of approximately $20,000,000 in Interstate General. This capital has given Interstate General the equity it needs to continue to provide housing for those markets most in need of new housing stock—entry level single-family homes and multifamily housing for low income and elderly families.

Based on this experience, I have the following observations:

1. Publicly traded partnerships will not result in the disincorporation of American business. The repeal of the General Utilities doctrine places a tax cost on liquidation that would, in most cases, never be recovered by the tax savings from operating in the partnership form. Since Interstate General was organized we have considered acquisitions of companies followed by their liquidation and have rejected this as a viable approach. Also, most business that intend to reinvest their earnings will not choose the partnership form of doing business since substantial distributions would have to be made to the partners to cover, at a minimum, their tax liability.

2. Partnerships have long been available as an investment mechanism for wealthy individuals to acquire professionally managed assets. This opportunity should not be limited to the wealthy, but should be available to all Americans. The only suitable vehicle for such investments is the publicly traded partnership.

3. It is unlikely that any substantial revenue would be gained by taxing publicly traded partnerships as corporations. As noted above, it is unlikely that many existing corporations will convert to partnerships. The liquidation spurt of 1986 is not being repeated in 1987. As this committee knows, the liquidation of a large number of corporations in 1986 to avoid the burden of the repeal of General Utilities produced unexpectedly large tax revenues. Furthermore, economic activity that would generate revenue would be curtailed if the publicly traded partnership vehicle were not available.

4. Any action taken by the Congress to curtail the availability of publicly traded limited partnerships should not apply to existing publicly traded partnerships. Expected revenues from such action would be greatly reduced or eliminated. The likely outcome will be that public investors will be eliminated through leveraged buyouts.
at discount prices reflecting the reduced value of their investment when subjected to double taxation. Once again the small investor would be denied the tax advantage offered to the wealthy investor.

(5) The use of a public partnership cannot be equated with a public corporation for tax purposes under existing law. It carries its burdens as well as its benefits e.g., pension funds, tax-exempt entities and individual retirement accounts are unlikely public partnership investors because of the tax on unrelated trade or business income. Moreover, partnerships are distinctive in that partnership agreements may be structured in ways that corporate charters may not. In this regard, one notable difference is that a partnership agreement may require distributions in certain circumstances, for example, a sale of certain assets. By contrast, corporate distributions are at the discretion of the board of directors.

(6) Congress should not change the ground rules so soon after enacting the comprehensive Tax Reform Act of 1986. More time is needed to study the practical impact of publicly traded partnerships on the economy in conjunction with lower corporate and individual tax rates. In the long run, I expect that publicly traded partnerships will be an important asset for our nation's economy allowing asset based businesses to compete for capital with service and other non-asset based businesses. Congress should not take action to eliminate this asset based on ivory tower tax theory or on revenue projections that will never materialize.

It is my hope that what I have outlined above will provide this subcommittee some practical insight into the real world problems that make the publicly traded partnership vehicle a desirable form of doing business for our economy. To summarize, I believe that the publicly traded limited partnership vehicle is desirable to enable asset-based businesses access to equity capital at reasonable costs.

Mrs. KENNELLY. Mr. Lee.

STATEMENT OF JOHN W. LEE, PROFESSOR OF LAW, MARSHALL-WYTE THE SCHOOL OF LAW, COLLEGE OF WILLIAM AND MARY

Mr. Lee. Thank you.

I am John Lee, a law professor at the College of William and Mary. I sort of reverse McKee's pattern. I have 13 years of practice and then I taught for 6 years. He was 13 years teaching and now is in practice. And I think we come at things from a different perspective.

We have heard a lot of talk about policy but I am not sure we have seen a lot of policy. If we look at classification criteria that are in the current 7700 regulations, we see under a deep structure analysis that the only logical difference is between an aggregate approach and a separate entity approach. An aggregate approach tries to treat the partner just as if he owned the property directly. An entity approach says you own an interest in the entity only. Assistant Secretary Mentz would say once you have a separate entity, you have got to tax it as a separate entity.

That doesn't follow. It is a different policy question as to whether the separate entity flows through or is taxed separately. The S corporation, it flows through; look at the C corporation, it does not.

When we begin to look at trying to distinguish between those entities that are like aggregates and those that are not, factors like public trading overlap the policy factors. Yet, if you have public trading most partners do not participate. At the same time, however, you can have a partnership in which most people don't participate, in which there is no public trading, and therefore the public trading is too narrow a line.

If what you are seeking to distinguish is between aggregate and entity, the line should focus on something like "material participation," something like being in there as a partner doing things.
Probably in some small, for example, 15-person, perhaps only general, partnership you could have inactive partners that should have aggregate treatment.

When you look at current corporations, S corporations, partnerships, MLPs, what I think you see is that the MLPs and the large partnerships would fall on the separate entity side. Small C's would fall on the aggregate side.

It was frequently raised by McKee and others, should we tax the two-man partnership like the two-man corporation. That is the wrong end of the telescope. The proper question is should we tax the two-man corporation like the two-man partnership, and the answer is yes.

A small corporation in which everybody materially participates should not be able to use the 15 percent inside graduated corporate bracket versus the 28 percent or phantom 33 individual brackets, that would apply in direct taxation.

Joint committee and Treasury told us in the 1985-86 reform there was no tax policy for those graduated close C brackets. If you are looking for revenue, there may be some there. There is a universe of 4 million corporations. We now have about a million S's, I think. I don't know what the number is for large C's—surely no more than 500,000. There are 1½ million corporations with no income at all. That leaves a million closely held C's that are using the inside brackets.

If all were using them to the maximum, it would be $5,000 per corporation, assuming 15 percent versus 28 percent—$5,000 and change. If there is a million times $5,000, that comes to $5 billion. That number is probably high. But there are surely $1 to $5 billion out there per year.

There is no real reason for that subsidy being there besides political ways to encourage capital formation. In my experience in practice, the owners took out the salary they needed to live on, then left in in the old days $25,000 to use the low brackets. It was simply a pocketbook to put the money in. There are things that are supposed to stop it, but they don't really.

So if we are going to be logical, we should do something like, where you are actually in there working, if you are, then you must be taxed directly; if you are not, we can have a separate entity, and that leads to the second question of what do we do with the MLP's.

Parenthetically, I think we would be doing the close C's a favor to make them pass through their income. People would use them for that $5,000 of tax saving a year. Yet what they run into are the accumulated earnings, perhaps personal holding company, unreasonable comp problems—I have a laundry list in my statement of the problems that come up—and General Utilities repeal, so when they sell the business they will have a double tax. As a result, many have gone to the S's—all should go S—or something like it.

As to the large limited partnerships and the MLPs where the people do not materially participate, they should be limited to an entity approach, which means if we allow them to pass through income and loss, that is all they do. If they sell the interest, it is simply selling an interest. It is not like they sold the assets as under the aggregate approach. If someone buys, it is not like they have bought the assets as under the (elective) aggregate approach.
Many of the problems in administration as to MLP’s come from attempting to use aggregate tools, allocation, and so forth, in an entity context.

As to integration, what it really comes down to—and people have talked quite a bit about subjecting these various entities to double taxes—is away from neutrality. The reality is what was decided in 1986 is that if you have active income, passive investor, that is largely held by high income individuals and tax exempts, they really don’t carry their share, in my view, and therefore the tax on the corporations was to do that.

So we have a concept of schedular income. If it is active income passive investor, then it has to carry that corporate sector tax load. That tax load is not 34 percent. The corporate tax load is about 22 percent of economic income. There is not double taxation, because they don’t pay out the dividends that much. It is maybe 10, 17 percent, so you can figure out what the revenue estimators have projected would come from the C sector per $100,000 of income as to annual realization by dividend or sale by the owners of the stock.

Whatever that rate works out to be, that is the rate—plus the base 22 percent—that should apply to the economic income of the MLP if you let it pass it through. My guess is the total rate would work out to be something like 28 percent of economic income.

I am saying, let MLP’s pass it through but the owners will be forced into a corporate minimum tax situation and some extra load for the fact that there would have been dividends at a small level had the MLP been a corporation, taxed at 28 percent. That would be revenue neutral because that schedular approach is the only thing that gives us horizontal equity—all of that type income is taxed the same. All income that is active with a passive investor should be taxed the same. And with that we will come closer to vertical equity, which is ability to pay. The people that own that income have the ability to pay and therefore it should be carried there.

My final point is if you are going to do this on policy, the only policy is something like material participation or pick some number, and I suspect the biggest gaming is in the close C area, not in the MLP area, and I suspect in practice the biggest gaming is the companies too big to go S, that instead do limited partnerships with their owners, various things.

On the 10th page of my statement, I point out some of the things I suspect go on there.

Thank you.

[The statement of Mr. Lee follows:]
Mr. Chairman and Members of the Subcommittee

My name is John W. Lee. I am a Professor of Law at the College of William and Mary where I have taught tax law for the past six years; previously I practiced tax law for 11 years in a medium size practice specializing in tax planning for small businesses (close C and S corporations), and in the early 1970's in partnership real estate tax shelter issues. I do not currently consult and while work on this statement was funded by the Marshall-Wythe Foundation and Alumni Fund, I am representing my own views today.

I. ENTITY CLASSIFICATION

A. Multi-factor Corporate Resemblance Approach

Traditionally most authorities formulate the classification issue in terms of pass-through entity versus separate (i.e., separately taxable) entity, see Treas. Reg. § 301.7701-1-2; Hearings on Issues Related to Passthrough Entities before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 99th Cong. 2d Sess. 8 (1986) (Asst Sec'y Mentz) ("Passthrough Hearings"). However, under a deep structure analysis the only universally valid functional classification distinction is between an aggregate approach and a separate entity approach (not necessarily as a separate taxpayer). Furthermore, the only determinative policy-based classification criterion is the owner's relationship to the business. The four traditional Morrissey factors (continuity of life, centralized management, limited liability, and free transferability), overly and short-sightedly mechanized by the current "Kimber" regulations, see Note, Tax Classification of Limited Partnerships, 90 Harv. L. Rev. 745, 750 (1977); Note, Tax Classification of Limited Partnerships: The IRS Bombs Tax Shelters, 52 N.Y.U. L. Rev. 405, 424-40 (1977), with the preponderance test's "thumb upon the scales" in favor of partnership status, Larson v. Commissioner, 66 T.C. 159, 185 (1976), only obliquely touch upon this relationship: essentially whether the owner actively or materially participates or is only a passive investor.

Under a deep structure analysis, material participation (or perhaps acting as the money person in a very small venture, say 15 general partners or the Service's upper benchmark for aggregate audit, Cf. Hearings on President's 1978 Tax Proposals before the House Committee on Ways and Means, 95th Cong. 2d Sess. 583-35 (1978), (statement of Commissioner Kurtz) ("1978 House Hearings"); is the sine qua non of "aggregate" treatment. For as the 1984 enactment of § 707(a)(2) reaffirmed the hallmark of an entrepreneur is material participation and entrepreneurial risk as to payment; under the aggregate approach the owner is treated as nearly as possible as an individual entrepreneur apart from the partnership, S. Rep. No. 1622, 93d Cong. 2d Sess. 99 (1954); Lane, Sot. Diamond: The Tax Court Uphelds the Service Partner, 46 So. Cal. L. Rev. 239, 253-61 (1973); see, Pratt v. Commissioner, 550 F.2d 1023, 1026 (5th Cir. 1977); Dept of Treasury, The President's 1978 Tax Program 118 (January 30, 1978), reprinted in 1978 House Hearings, 95th Cong. 2d Sess. 277 (1978); Cf. Joint Committee Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 2d Sess. 236 (1984); Holiday Village Shopping Center, Inc. v. United States, 773 F.2d 276, 282 (Fed. Cir. 1985). The quintessential individual entrepreneurial characteristic is such material participation. Ideally the aggregate approach applies in virtually all aspects except audit, reporting and perhaps characterization of income. In contrast, under the entity approach the taxpayer is not treated as having any inside interest in the entity's assets, only an interest in the entity. See Holiday Village Shopping Center, Inc. v. United States, 5 CL Ct. 566, 570 (CL Ct. 1984), aff'd, 773 F.2d 276, supra. A pass-through in such an entity is limited to a prorata share of income and loss and tax-free withdrawal of investment and retained earnings and no more, i.e., essentially Treasury's preferred approach to Subchapters K and S, see Passsthrough Hearings, supra at 15-16, 36. These traditional classification criteria do not speak in any way to whether the entity should be taxed separately or should pass through its income/loss and permit tax-free withdrawal of investment and earnings. Whether an entity should be able to pass through poses different policy questions discussed below.

The case-law matrix, which existing corporate resemblance regulations mechanized, rests upon the franchise privilege-benefit rationale for corporate taxation. Compare Morrissey v. Commissioner, 296 U.S. 344, 359 (1935) with Flint v. Stone Tracy Co., 220 U.S. 107, 162 (1911), and corresponds in large part with Congress' early understanding of the business purposes for incorporation (limited liability and continuity of life), Scallen, Federal Income Taxation of Professional Associations and Corporations,
10-19

49 Minn. L. Rev. 603, 613 (1965). Nevertheless, only "centralized management," as reinterpreted in the June 1986 Passthrough Entity Hearing Pamphlet, Joint Committee Staff, Federal Income Tax Treatment of Pass-Through Entities, 91st Cong. 2d Sess 13 (1986), of the 4 factors functionally corresponds with the deep structure policy of basing aggregate passthrough treatment on entrepreneur activities. Reflection on large service partnerships proves this point. Conversely, commentators and witnesses at various hearings have argued that most, if not all, of the 4 traditional corporate advantages and hence characteristics are functionally in fact usually not available to a close corporation and its owners. Passthrough Hearings, supra at 19, 28 (Asst Sec'ty Menta); Id. at 43, 51 (McKee & Keller); which probably constitute approximately 90% of all corporations. I agree; most close C corporations exhibit none of Reg. § 301.7701-2(d)'s four corporate characteristics: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of unit of ownership.

First, notwithstanding the perpetual continuity of a corporate charter, when the principal dies, the business will terminate or be sold unless management successors have been or can be soon arranged. See Kessler & Yorio, Choosing the Appropriate Form for the Small Business, 1 Corp'n L. Rev. 291, 298 (1978). In close C corporations with very narrowly held stock, key shareholders tend also to constitute the board and key officers— a pattern of overlapping positions reaching its extreme usually in sole shareholder operations where complete identity between the board, officers and owners commonly exists. Thus, centralized management is non-existent in most close corporations. Limitation of liability is often a chimera as well for close Cs. Significant third party creditors (except perhaps in real estate ventures) usually require guarantees by principal shareholders and their spouses. Passthrough Hearings, supra at 19 (Asst Sec'ty Menta); Kessler & Richmond, Is C Corporation Obsolete for the Small Business?, 7 Corp'n L. Rev. 293, 294 (1984). Furthermore, an active shareholder may be personally liable for his/her own torts in the scope of his/her "employment" and possibly in supervising others. Kessler & Yorio, supra at 302-04. Finally, the assets of the corporate business itself, always subject to the entity's liabilities, are often the principal asset of the entrepreneur. Free transferability also misses the mark in a close C where the real problem is finding any secondary market at all for minority close C stock. Here a put-option buy-sell with the corporation and/or co-shareholders and right of first refusal are quite the standard.

Conversely, by skilled drafting most of the big 4 corporate advantages can be obtained by entities that traditionally have been viewed as partnerships, particularly large limited partnerships, i.e., over 15 partners, see 1978 House Hearings supra at 277. Until Reg. § 301.770-2(a)(3) instituted (in 1960) the ill-fated preponderance (more than 2 out of 4 "corporate" characteristics) test, certainty as to classification was virtually impossible. Most suggestions for a multi-factor approach recreate such uncertainty, particularly the Larson call for de-mechanization, unless the thumb on the scales is simply reversed to apply a preponderance test as to non-corporate status. But the most serious defect in the current classification regulations is that the resemblance-characteristics multi-factor approach has never been clearly directed at any underlying identifiable policy, unless certainty in itself is viewed as a policy—as some do indeed argue. See Passthrough Hearings, supra at 28; Note, 52 N.Y.U.L. Rev. supra at 440.

Commentators have advocated myriad changes to the multi-factor approach, generally settling on one factor or another as determinative, either (a) limited liability, Note, 90 Harv. L. Rev. supra at 757 (personal liability); Keyser, Publicly Traded Limited Partnerships: The Treasury Fights the Wrong War, 36th Inst. on Oil & Gas Law & Tax'n 10-1, 1-18 - 10-19 (1985) (recourse liability with substantial general partner); Hyman & Hoffman, Partnerships and "Associations": A Policy Critique of the Morrisey Regulations, 3 Real Estate Tax'n 377, 381, 397 (1976) (state law characterization should be determinative) (future test should be reasonable one, "sitting the number of owners and types of complexities of capital interests... [permitted for passsthrough status]"); Postlewaise, Dutton & Magette, A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Georgetown L.J. 396, 458 (1987); Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 897 (1987); or (b) whether the owners' interests are publicly traded, see Outlaw v. United States, 494 F.2d 1376 (Ct. Cl.), cert. denied, 419 U.S. 844 (1974) (other factor); Peet, Definition of a Partnership: New Suggestions on an Old Issue, 1979 Wisconsin L. Rev. 989, 1012-13, 1016 (rough, rule of thumb) (any 3 out of 4 or limited liability plus public trading); ALI, Federal Income Tax Project Subchapter K: Proposals on the Taxation of Partners 392-93 (1984). None of these proposals accurately distinguish between an (a) aggregate or collection of individuals and (b) an entity. Nor does reworking the relative weight to be given the 4 traditional corporate resemblance factors, and including other
factors, such as public trading, all as suggested by the Tax Court in Larson v. Commissioner, 66 T.C. 159 (1976), promote predictability or the underlying policy of aggregate treatment only for entrepreneur characteristics.

B. Proposed Classification Standards: Relationship to the Entity's Business

Both the Treasury position at the Pass-Through Hearings last Summer and the accompanying Hearing Pamphlet attempt to base pass-through treatment on the "relationship between the entity and its owner," Pass-Through Hearings, supra at 11; Pass-Through Hearing Pamphlet, supra at 13-14. However, only lack of involvement in management or operation corresponds with the underlying policy of requiring separate entity status where most owners do not actively participate. If substantially all of them are not involved in the entity's management or operations, no functional basis for an aggregate approach exists; policy thus calls for an entity approach. Conceivably, albeit not unlikely, an entity with a large number of owners and publicly traded ownership interests may have a large number of owners involved in the management or operations. More significantly the absence of these factors does not guarantee material participation. Thus, Treasury's publicly traded standard is clearly too narrow leaving undisturbed, (a) the more serious debt backdoor integration, see Camellios, Corporate Tax Integration: By Design or By Default, 35 Tax Notes 999, 1002, 1007 (1987); Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 890, 898 (1987), and (b) gamesmanship in a close, but large C with "spin offs" through large non-publicly traded limited partnerships, which functionally resemble MLP's and large C corporations. See Hearings on Reform of Corporate Taxation Before the Senate Committee on Finance, 98th Cong. Ist. Sess. 160, 365, 375 (1983) (statements of John S. Nolan, Southwest Realty, and Timber Realization ("Senate Subchapter C Hearings")). This Treasury surely added the frequent change of ownership and access to capital markets factors just in order to narrow the targeted group effectively to master limited partnerships, and not all large limited partnerships. Former Assistant Secretary for Tax Policy Ron Pearlman believes that publicly traded interests indicates corporate status but is not be determinative. See Sheppard, Rethinking Limited Partnership Taxation, 30 Tax Notes 877, 879 (1986). In the past Treasury has opposed such a piecemeal approach to classification. See Senate Subchapter C Hearings, supra at 11, 14-15 (Pearlman); Cf. 1984 House Tax Shelter Hearings, supra at 40 (Asst Secretary John E. Chapoton). But see Dept Treasury President's 1978 Tax Program at 117-20 (1978), reprinted in 1978 House Hearings, supra at 276-79.

While publicly traded interest practically means that the majority of the owners do not materially participate, and hence should be limited to an entity relationship; the same cannot be said about the other single classification factor currently advocated, namely limited liability. An entity in which substantially all of the owners materially participate in the business could have nonrecourse financing, or more likely not have any substantial debt, e.g., a service organization, and insurance against all substantial risks. Indeed Congress itself in § 469 recognized that liability and material participation were not synonymous. "The distinction that the Committee believes should be drawn between activities on the basis of material participation bears no relationship to the question of whether, and to what extent, the taxpayer is at risk with respect to the activities." S. Rep. No. 313, 95th Cong. 2d Sess. 717 (1982). Moreover, the absence or presence of liability does not address the underlying aggregate issues. Compare id at 717 n.6.

In fact, a functional aggregate analysis could readily use the new "material participation" standards of § 469 as a starting point in determining whether the entity should be treated as an aggregate of its owners. The "material participation" standard also looks at the relationship of the owner to the activity of the entity. "The relationship to an activity of an investor who does not materially participate may be little different from the relationship of a shareholder to a corporation." S. Rep. No. 313, supra. The actual approach probably should not track the detailed rule after detailed rule applied to passive activity losses. For example, the automatic PAL exclusion of real estate from material participation, except in narrow circumstances, probably is inappropriate. Conversely, limited partnership status, regardless of public trading, functionally appears an interest that does not materially participate and, hence, would be limited to an entity approach. Material participation for this purpose should not be limited to performance of services by the owner. In a small enough operation, for example, the classic moneyman and service provider, a general partner moneyman should be deemed to materially participate. Probably the benchmark for such deemed materially participation should be 15 partners including the investor (general) partners.
Moreover, following through logically, most closely held C corporations would functionally be aggregates and, hence, should not be entitled to defer taxation to the owner until distribution of profits. Treasury would avoid this little problem (encompassing probably 90% of all corporations) by granting automatic non-corporate status to a general partnership and automatic corporate status to a formally organized corporation, Pass-through hearings, supra at 28, in effect only applying the relationship to the entity analysis to limited partners, indeed, publicly traded limited partnerships or Master Limited Partnerships.

In the context of the MLP issue currently before this Subcommittee, the first policy question as to a Master Limited Partnership is whether its owners should be entitled to aggregate treatment or be limited to separate entity treatment. Assuming that the bulk of the owners in a Master Limited Partnership do not materially participate, such Master Limited Partnership should be treated as a separate entity. Such owners are not entrepreneurs, they are mere investors. Thus, no inside basis adjustments, fragmentation as to sale or purchase, etc., should be available. The same denial of partnership aggregate pass-through should apply at least to large (over 15 partners) limited partnerships in which the majority of partners (by percentage interest) do not actively participate. Pass-through of income or loss is a separate issue as indicated above, and is discussed below. Ironically, the uncles, if not the fathers, of current subchapter K anticipated that small partnerships would opt for aggregate treatment and intended the entity election aspects of current subchapter K for larger partnerships. Hearings on General Revenue Revision before the House Committee on Ways and Means, 83rd Cong. 1st Sess. (Part 2) 1970 (1953) (statement of Mark H. Johnson, on behalf of American Bar Association) ("1953 House Hearings"); Jackson, Johnson, Surrey & Warren, A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners--American Law Institute Draft, 9 Tax L. Rev. 109, 129-30 (1954). My suspicion is that the present situation in practice inappropriately is completely the reverse. Cf. Canellos, supra at 1006; Leonard, supra at 895. We need to get back to the basics of aggregate treatment.

II. SEPARATE TAXATION OR PASSTHRough: INTEGRATION

A. Introduction

If a majority of the partners in a partnership actively participate in the entity's business, the partnership and its partners should be permitted aggregate pass-through tax treatment (the rationalization of current subchapter K). Probably the same treatment should automatically be available based upon a size limitation, say 15 partners (perhaps limited to general partners). Presumably, also, such a partnership and partners would be entitled for "simplicity" to elect one time for entity-conduit or entity pass-through tax treatment (the rationalization of current subchapter S). At the same time, if a majority of the shareholders in a (close) C corporation actively participate in the entity's business, the C corporation and its shareholders should be taxed under a pass-through regime elective (a) aggregate pass-through or (b) entity-conduit or pass-through. Again, a mandatory pass-through rule probably should apply to close C corporations with under 10 or 15 shareholders (perhaps treating economic family and business groups as a single shareholder). The practical effect of a mandatory pass-through could be easily obtained by (a) eliminating the graduated close C tax brackets under the present regime, and (b) easier election of pass-through treatment.

Large limited partnerships, including but not limited to Master Limited Partnerships, and (large) C corporations conducting a big business (over $100,000 net profit(s) in which the majority of the owners do not materially participate should be restricted to a separate entity approach. Under the current system of corporate and partnership taxation this would mean the current C double taxation approach. The possibility of entity-passthrough or "integration" for such large entities is discussed below.

B. Close C Corporation: Mandatory Integration

1. Mandatory Pass-through of Income and Loss at Entrepreneur's Rates

Since there is no policy reason for taxation as a separate entity to produce less taxation than direct taxation, particularly where the owners materially participate, in such close C's at least pass-through of income and loss should be mandatory to end the inside tax shelter. Lee, Capital Gains Exception to the House's General Utilities Repeal: Further Indulgences from Overly Processed Corn Products, 30 Tax Notes 1375, 1384 n.39 (1969) (small C's); House 1978 Hearings, supra at 3318-19; 9 Tax Revision

Due to the transactional tax costs to such inside shelter (particularly the repeal of General Utilities) discussed below, mandatory pass-through now would actually do small business a favor—which they will need. In 1982 there were 564,219 S-corporations (260,558 reported a net loss, probably reflecting traditional profit preferences). See Hearings on High-Income Taxpayers and Related Partnership Tax Issues before the House Ways and Means Subcommittee on Oversight, 97th Cong. 1st Sess. 73 (1985) (statement of Ass't Secretary Pearlman). In the last 2 months of 1986 and first two weeks of 1987, 220,000 S elections were filed. See Leonard, supra at 894. The million or so other close C corporations will find that the 2-year transmissive rate for close "small" Cs as of 12/31/84's 10-year tint contains an exception for built-in ordinary income, e.g., profits, which is subject to double tax as the inventory items or amounts receivable are collected, albeit more in the latter, than the former, see Volpi, S Corporations Before and After the TRA, Tax Adviser 365, 372 (June 1987).

Additionally, sales of larger close Cs (before or after converting to S status) trigger, directly or indirectly, double taxation on the built-in appreciation rate. This corresponds to the close C inside shelter previously enjoyed. That shelter was the lower C inside rates, plus deferral. Assume that the Cs inside rate was 25%. The minimum inside bracket varied from 30% to 15% under the 1954 Code. Assume also the owner's marginal rate was 50% (that too varied from 91% to 59% under the 1954 Code, but the base was frequently eroded, even totally). If the entity has $75 E&P and we assume $25 in close C entity-level taxes, then hypothetical grossed-up earnings are $100. Had the owner earned this $100 directly, he/she would have paid $50 in taxes. Borrowing from the employee benefit tax area, the deferral privilege should cost 10% of the deferred amount (10% x $75). So the hypothetical tax would be $7.50 with a credit for the $25 deemed paid by the entity. So the proper net tax to purge the C E&P is $32.50, which is approximately 45% of accumulated E&P. I might point out, close C's witnessed a similar 20% toll charge (20% of excess of inside minus over outside basis) for C to S conversion ably presented by Professor Ginsburg (and adopted by the ABA Section of Taxation) to the House Ways and Means Committee in 1982. See Hearings on H.R. 6055 (Subchapter S Revision Act of 1982) before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, 97th Cong. 2d Sess. 98-99, 118, 151-53, 201, 206, 209-10, 216-35 (1982). Whether the newfound enthusiasm for integration can swallow this toll charge this time is another story. An answer might lie in prorating the toll-charge over say 5 years as Professor Ginsburg also suggested, id. at 225-26. Under this model, basis step up would be proportionately limited this time—year by year to the percentage of the tax paid. Alternatively, borrowing from the S 108 elective regime and Professor Ginsburg's observation that a basis reduction is equivalent to an increase in future income, id. at 217, former Cs could reduce basis by an appropriate charge instead of an imputed "realization" toll charge.

Under such mandatory pass-through, close Cs should be entitled to elect an aggregate (K model) pass-through, as witnesses have often suggested, see Passsthrough Hearings, supra at 95 (statement of John Pennell); Hearings on General Revenue Revision before the House Committee on Ways and Means, 85th Cong. 2d Sess. (Part 1) 47 (1958) (colloquy between Congressman Koegh and Sheehan); 1953 House Hearings, supra at 1291 (statement of American Institute of Accountants); (the Senate in 1954 in proposed § 1351 would have allowed a qualifying corporation to elect tax treatment as a partnership, with (a) a 10 shareholder notice provision, (b) limit, (c) restrictions on partners and non-resident aliens, and (c) a single class of stock, S. Rep. No. 1622, 83d Cong. 2d Sess. 452-53 (1954) (the provision was stricken without explanation in Conference), as well as probably an S or entity pass-through model.
2. Conventional Close C Tax Planning

Conventional wisdom advocated "manipulation" of (a) outside individual income rates as to "compensation" from the enterprise and inside graduated C corporate rates on its retained income in the small closely-held corporation context, in order to obtain an "inside tax shelter." See supra. This abuse was pointed out to Congress long ago. 3 Tax Revision Compendium, Compendium of Papers on Broadening the Tax Base Submitted to the House Committee on Ways and Means at 186-87 (1958) (statement of Janin); see also Hearings on the Revenue Act of 1958 before the Senate Committee on Finance, 85th Cong., 2d Sess. 133 (1958) (Sec'y of Treasury Blumenthal) ("We think this graduation at the bottom of the inside corporate tax rates is really what has been referred to in the literature as the ultimate tax haven, tax shelter, for a high income individual"). Thus, the regular C corporation was "ultimate tax haven, tax shelter"—under the 1954 Code for the closely-held business annually retaining $100,000-$200,000 in profits and paying out the rest of its profits as hopefully deductible compensation to principals. See Starr, S. Corporation: Is It the Right Choice?, 43 N.Y.U. Inst. on Fed. Tax. 5-1, at 5-36 (1985). See generally Watkins & Jacobs, Closely Held Business: Tax Planning After ERTA, 9 Tax Adviser 516 (1982). Such manipulation, coupled with a date of death step-up in basis at the owner level in the corporate stock upon his/her death, $1014(a), and under the 1954 Code codification of General Utilities non-recognition at the inside corporate level on inside gain upon a taxable disposition of the C corporation or its assets, §§ 336, 337 and 338, meant as a practical matter that use of a C corporation, far from resulting in double taxation on corporate income from operations and appreciation in assets, often actually yielded under the 1954 Code less total taxes at the combined shareholder and corporate levels, than if the principal had not incorporated the venture in the first place. Sen. Fin. Comm. Staff, Preliminary Report, The Reform & Simplification of the Income Taxation of Corporations, S. Print 95, 95th Cong. 1st Sess. 88 (1983). This absurd result can not be justified by any tax policy. Id, at 88 (Other than capital formation as discussed above, and surely better ways exist for that purpose). The real issue, therefore, under the 1954 Code was not double taxation, but whether the Service would collect one tax time. The amount of this tax expenditure could be as high as $5 billion a year (1,000,000 close Cs x $5,000 ($50,000 x 13% spread)) if so, it should be better targeted, e.g., to minority businesses, etc.

3. Hidden transactional costs under the 1954 and 1986 Codes.

Such use of a C corporation as an inside tax shelter entails, however, substantial transactional tax costs, and is the source of much, if not most, of the 1954 Code corporate shareholder tax complexity and endless administrative controversy in the corporate and shareholder taxation arena, which continues under the 1986 Code. For example, balancing the income from the venture between compensation to principal and retained taxable income not exceeding the lowest corporate graduated brackets generates the problem of "unreasonable compensation" not deductible to the corporation. Retention of corporate earnings to obtain the lower inside tax bracket rather than payment to shareholders, triggering true double taxation, poses "accumulated earnings tax" problems, see Watkins & Jacobs, supra; Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reform before the House Committee on Ways and Means, 98th Cong. 2d Sess. 156 (1984) (statement of Martin Ginsburg) (hereinafter "Tax Shelter Hearings"); with clumsy retention of earnings for a personal investment program, personal holding company tax problems instead. Furthermore, splitting personal service income between a close C and the shareholder-employee gives rise to intense § 482 deemed arm's length reallocation of income or deductions problems. Even if the retention of profits at the corporate level is ultimately respected, attempts to realize the economic benefit at the shareholder level prior to the sale of the business often creates new tax problems, e.g., whether (a) withdrawals structured as "loans" constitute constructive dividends (a recent study by my colleague Jayne Bernard demonstrates that in her sample of previously close corporations engaged in an initial public offering, nearly 50% had made substantial loans during a 3-year lookback to their officers or directors; the comparable figure for publicly held corporations is 16%), (b) sale/exchange or dividend treatment applies to redemption payments upon retirement, as well as, (c) whether the "collapsible corporation provisions will apply. The latter problem areas (b) and (c) should disappear, except for basis recovery in redemptions, if the 1986 elimination of the capital gains preference actually comes into effect and remains in effect. Finally, offsetting the use of a C as an inside tax shelter was one of the primary (post-facto) policy justifications for the 1986 repeal of General Utilities. See Sheppard, General Utilities Repeal, 33 Tax Notes 183 (1986).

a. The lowering of the individual income tax rate leaves out does not eliminate the spread between the graduated inside corporate tax bracket for small corporations (e.g., 15% up to $50,000) and the maximum outside shareholder tax bracket. Moreover, the maximum inside corporate tax brackets of 15% or greater than the maximum individual tax brackets of 28% and "phantom" 33%. However, some still recommend the inside shelter of a C. See, e.g., Kramer, Take a Hard Look Before Electing Shareholder Status, 1 Tax Times 14 (Dec. 1986).

b. The repeal of General Utilities and perhaps even more significantly the protection of new restrictions on C to S conversions to a detriment of the individual and corporate income tax base, in some cases, implies a true second tax upon disposition of a stock or assets of C corporation or its assets by an S in which C E&P has been retained. This repeal may be viewed as a surrogate tax for the prior use of the close C inside shelter. See supra, Notes 184. I am indebted to Edwin Cohen and Samuel Thompson for the insight that the repeal of the General Utilities shield in this context acts, however, as a pseudo surrogate levying a penalty or toll charge often disproportionate to the crime. As a practical matter, the new C to S conversion penalties and the ordinary corporate income tax on the 2-year transition rule for C to S conversions in their present form, will probably eliminate the present of 1986 closing date the inside C to S conversion of a C corporation election to avoid accumulated earnings tax and the more intense maximum corporate rate once substantial profits have been retained and substantial profitability from operations is attained—a common 1984-Code technique.

The practical impact of the General Utilities Repeal is that among C's lower than $10,000,000 must face an immediate inside (§ 336) and outside tax (§ 1031) upon conversion directly to pass through status as in a Master Limited Partnership. This practical matter, therefore, is unlikely to occur. See Passthrough Graham, supra at 38, 50. As discussed below, many partnership spin-off techniques are being designed to pass future appreciation and income attributable thereto directly to the owners or partners.

For a small C corporation, i.e., under $5,000,000 or subject to and new §§ 336 and 1374, etc., for $5,000,000 to $10,000,000, the S mechanism offers the best pass-through.

However, the practical effect of new § 1374 and the 2-year transition rules for close, "small" C's converting to S is that while the double tax on appreciated investment or operating assets can be avoided by waiting out the 10-year period of new § 1374 as to ordinary income assets or three years as to capital gain assets for transition rule 9's under-old § 1374 (or clever use of installment reporting), the practical toll charge is a second tax on built-in gain in operating profits at conversion. Ordinary income is not subject to any transitional rule and whether in the form of accounts receivable of a cash basis taxpayer or inventory of an accrual basis taxpayer are subject to one degree or another to new § 1374's double taxation. See Joint Committee Staff, General Explanation of the Tax Reform Act of 1986, 100th Cong. 1st Sess. 786 n.239 (1987). Arguably in services enterprise the double taxation sting can be avoided by "offsetting" compensation payments to the principals, subject to reasonable compensation limitations.

In my view, current § 1374 and the transition rule constitute inappropriate models for dealing with wholesale conversions from close C to S (as is full reformation inside and out upon conversion of a close C to a partnership), particularly where the owners materially participate. The appropriate toll charge (for purging C E&P) is discussed above at p. 5 of this statement.

c. Eliminating the capital gains preferential tax rate affects the ability of the shareholders to withdraw the retained earnings at a preferential outside rate through redemption or sale. But 28% is not that much greater than 28%.

d. Additionally, the 1986 Code corporate minimum tax applicable to C corporations is in some cases more restrictive than the minimum tax applicable to non-corporate partners and shareholders in S corporations, particularly as to book income, whatever that means.
The 1986 PAL provisions ($469), when fully phased in, largely will end the tax free status of partnerships and S corporations to conduct a "passive loss" generating active non-intentional tax shelter, since they pass such passive losses through (retaining the tax consequences) to their shareholders or limited partners. However, a close-corporation non-passive C corporation can offset "business income," but not portfolio income, with passive losses, §469(e)(2), an anomaly to the extent most owners of close C's actively participate; the current portfolio income exception does not go far enough. But again, once you put a passive loss activity in a corporation, you create a new set of automatic transactional tax costs, e.g., evidence of bad motive for accumulated earnings tax and double tax upon distribution, etc.

A mandatory payment of income and loss to close C corporations in which a majority of the shareholders materially participate would simplify greatly tax administration and tax on small businesses. Moreover, with the elimination of the close C bail-out pressure, there would be open for substantial simplification of Subchapter C. Cf. Senate Subcommit on H.R., supra at 230-31; Mills Tax Revision Hearings, supra at 855, 885-886.

C. Publicized New Entree

1. Introduction.

From 1954 to 1994 there was a tax shelter for high income taxpayers subject to 70% to 80% of their income. The nominal big C corporate rate was around 50%. See Mills Tax Revision Hearings, supra at 351, 363-64, 393-94; 1973 House Hearings, supra at 3923-24 (Gaffney). The average effective rate was much less during this era due to use of preferences and/or tax shelters. Moreover, how capital gains rates at the shareholder level or date of death step up or result in little or no income tax compared with direct taxation. Skillful tax planning could make the income tax as to active business income earned in corporate sector voluntary as the estate tax. Truly, the question was not double taxation but severe under-taxation. Now the public C deferral-shelter has disappeared: a "momentum" flat 34% inside vs. flat 28% (after 5% clawback hump at $50,000 to $150,000 annual income). The reality is a little different: With preferences and debt eroded corporate tax base, the corporate effective rate is brought up to the low 20% only through the corporate minimum tax and BURP.

The "corporate sector tax," being borne in the short-run by big C shareholders and in the long-run primarily by the owners of capital in general, to that extent adds some progressivity as to large income individual and tax-exempt shareholders. Thus, a corporate sector tax would have some vertical equity, i.e., progressivity based upon ability to pay, to the current extent. More significantly, at least in a political sense, is the operative fact that the increase in the corporate sector tax (as well as the pre-1986 Act estimated corporate sector tax) was clearly the glue that held together the 1986 Act with its goal of an equal percentage reduction income class-by-income class on the individual side, largely opposed by a corporate sector increase (although half of the corporate increase consisted of timing changes). Congress and Treasury should not now change the mix. And it does not appear that either intends to. If the "corporate sector tax" is functionally translated as a tax on "schedules corporate sector income," i.e., active business income earned by an entity in which a majority of the owners do not actively participate, and horizontal equity in terms of treating all such schedule income equally and not in described policies demand that any form of large separate entity integration for large C's, S's or large limited partnerships--active businesses with passive owners--not be revenue and distributionally neutral.

Integration of many C corporations is not now politically feasible (revenue and distributionally neutral or not) due to the continued hostility of corporate management and tax-exempt shareholders to any form of full integration. The former, because they like being money managers; the latter either because they don't understand the current incidence of corporate taxation or because it would be the first step to imposing some income tax on tax-exempt holders of both equity and debt instruments to maintain a level playing field (although the basis in the present system towards debt would continue as to tax-exempt debt owners). While populists may now, as I do, unlike earlier favor integration of large C's provided that the projected corporate sector tax is borne directly by the owners in an expanded entity-conduit regime, probably through a non-refundable credit.

C. Shepley, Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax, 27 Tax Notes 637 (1985) with 1978 House Hearings, supra at 3504, 3507, 6107-10 (statement of Sheldon Cohen); the political balance still appears against big C tax reform. In the Senate, A Pragmatic View of Corporate Integration, 35 Tax Notes 888, 889 (1997) (Hearings on Reform of Corporate Taxation Before the Senate
Finance Committee, 98th Cong., 1st Sess. 2 (1983) (statement of Chairman Dole; "It is pretty clear to this Senator that politics and economics will prevent any radical change [such as abolishing the corporate level tax or taxing shareholders on all corporate income without regard to its distribution] in the near future.")

As to "Master Limited Partnerships" clearly the current classification and tax treatment as an "aggregate" passthrough entity is inappropriate from a policy perspective because most if not all owners of MLP's do not materially participate in the entity's active business. Therefore policy mandates separate entity treatment rather than an aggregate passthrough treatment. This raises the question then whether the MLP as a separate entity should be entitled to passthrough or conduit treatment in the form of full or partial integration. First the current non-partnership passthrough model (other than S corporation) do not appear appropriate, although I do not profess to any special expertise as to regulated investment companies, real estate investment trusts, and their newer analogues. It appears to me however, from testimony in prior hearings that the hallmark of passthrough as to such entities is that the income of the entity be passive. Here we are concerned with active income/passive investor. Nor does the trust appear to be permitted a more rigid unit of ownership model and no inside basis adjustments or special allocations would be permitted.

2. Schedular Passthrough or Double Taxation.

Since progressive rates have been compressed, horizontal and vertical equity with passthrough of separate entity income, i.e., MLP's and certain large limited partnerships can only be obtained through passthrough of "schedular income" (active business and inactive unit owners) which carries with it at least the targeted "corporate sector tax" burden as such such as $100,000. I call this the "F.N. Bard" proposal, in honor of the Illinois rancher, farmer and small manufacturer who proposed in the 1953 House Hearings (as well as on many other occasions) that partnerships be allowed to elect (then lower) C corporation rates as to business income, with regular higher individual rates on portfolio income, 1953 House Hearings, supra at 1363 (statement of F. N. Bard)--a schedular income idea before its time and partially enacted in little used and now repealed Subchapter R. Of course, Bard wanted the inside C shelter so a partnership could compete with corporations. Id. at 1368.

Simply taxing such "corporate sector" income directly to the individual partners in MLP's and large limited partnerships at 34% on the existing corporate sector tax base, probably would produce only an effective rate of say 22% on economic income (and only then if corporate-like minimum tax and timing shift's apply) and at the same time would ignore the usually deferred and minimal "double taxation" at the non-tax exempt shareholder level on ultimate owner "realization" through "dividends," sale or liquidation, etc. The more simple and probably most equitable "integration" treatment of MLP's and large limited partnerships and their partners as to such "corporate sector" schedular income (active business, passive owners) would be to provide an election: (1) treatment in all ways as a large C with an entity level 34% rate on the existing corporate base with an inside corporate-like minimum tax, plus an outside shareholder level 28% tax as to taxable realizations by partner-owners, or (2) an entity-conduit integration along rationalized S model lines with preferably a 28% (or phantom 33%) tax at the "partner" level on the entity's economic income, i.e., without preferences or timing distortions, regardless of whether distributed, with a bias increase for subsequent tax-free withdrawal at the partner level. Such treatment of MLP's and large limited partnerships could be a model for ultimate integration of large C's were the politics ever to change. Remember that they thought that there would be no 1986 Code.
The losses of such a separate active business entity with passive owners would not shelter other income of the taxpayer partner, whether from services, portfolio, or similar non-aggregate passthroughs. Treasury has ample authority under current § 469(k)(3) to handle this problem without further legislation. See Passthrough Hearings, supra at 13–14 (awareness by Treasury of MLP's as method of gaming PAL rules unless special precautions are taken, viz. § 469(k)(3)). Therefore, merely providing that MLP's income is portfolio income for purposes of the PAL provisions is not really a compromise position by the industry. Treasury already holds that card.

If such scheduler passthrough of income or full integration at least as to income is not feasible, politically or administratively, then MLP's and their partners and large limited partnerships and their partners should both bear the current subchapter C double taxation regime as to "corporate sector income."

III. USE AND NATURE OF MLP'S

Commentary and witnesses in prior hearings have pointed out that the revenue amount involved in taxing MLP's as large C's is not significant, and there is no widespread disincorporation of existing large C corporations. However, under the current rules taxpayers with expert advice will structure new ventures, as in the high tech area, as limited partnerships, see Pass-through Hearings, supra at 38–39 (statement of Assistant Secretary Mentz), partially in anticipation of the entity going public without triggering a post-General Utilities repeal tax as to appreciation in the entity's assets. This alone makes the playing field unequal. 14

Commentators and witnesses at other hearings have also explained that under the current partnership rules (especially special allocations) MLP's and limited partnerships will be used to "spin off" portions of a business of an existing large C corporation through transfer of such portion to a limited partnership in exchange for a general partnership interest. See Freeman, Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Drafting Partnerships onto C Corporations, Running Amok with the Master Limited Partnership Concept and Generally Endeavoring to Defeat the Pension of the Draftermen of the Repeal of General Utilities, 64 Taxes 962, 967, 975 (1986); Hearings on Tax Shelters, Accounting, Abuses, and Corporate and Securities Reforms Before the House Ways and Means Committee, 98th Cong. 2d Sess. 469–70 (1984) (statement of David Glickman); Senate Subchapter C Hearings, supra at 518–21 (Id.); Cf. Sheppard, Walk This Way: Taxing Publicly Traded Limited Partnerships as Corporations, 35 Tax Notes 66, 87 (1987). In this least-abusive spin-off the limited partnership interests are either distributed to shareholders or sold to the public. In a more sophisticated version, variations of partnership "estate freeze" special allocations are utilized in such a limited partnership with the goal of shifting future appreciation, income and opportunities attributable thereto to the limited partners. In this scenario the C corporation receives a frozen general partnership interest with future value going to the limited partners, who may indeed be shareholders in the corporate general partner. See Freeman, supra at 979. More aggressive, in my opinion, are flip-flop allocations of operating income coupled with a different ratio for sharing appreciation in the underlying business assets. Freeman, supra at 979. Most gamy would be a combination of some, or all, of the above in a close C context in which substantially all of the limited partnership interests are acquired for a nominal amount by the shareholders of the close, but large C corporation, which after the transfer of its business for a substantially frozen general partnership interest, then elects Subchapter S status. Since the limited partnership interests are not publicly traded, the preferred approach of Treasury as to classification would not stop this gamesmanship. Rewriting the § 704(b) regulations to (a) properly reflect an aggregate approach and, hence, time value of money and assignment of income principles, and (b) remove the thumb on the scales as to ACRS deductions, no longer policy-based after PAL, would halt the most egregious abuses. The step transaction and proper aggregate approach as to § 704(b) allocations would prevent by-passing § 1374 by the former C, now S corporation. Only a deep structure revision of subchapters K and S limiting MLP's and limited partnerships in which most partners do not materially participate to an entity-conduit regime with no special allocations (and integration only through a passthrough of scheduler corporate sector income) would end all gamesmanship here.
STATEMENT OF LEWIS H. SANDLER, GENERAL PARTNER, SOUTHWEST REALTY, LTD., AND ON BEHALF OF THE NATIONAL APARTMENT ASSOCIATION

Mr. Sandler. I am Lewis Sandler. I appreciate your permitting me to appear today on behalf of the National Apartment Association and Southwest Realty, Ltd., a publicly traded master limited partnership engaged in real estate, primarily multifamily units in the Southwest.

Southwest Realty commenced operations and trading of its depositary receipts in February 1983. At that time we didn’t know what an MLP was. We had never heard of one. Southwest Realty was created through a so-called rollup of 14 existing partnerships, each owning its own cash flowing, income-producing property in which my two partners and I were individual general partners.

There were three major considerations behind our rollup, none tax-related. The first and foremost consideration was liquidity. We have heard a lot about that, so I think I will move on and just mention that with respect to liquidity, Southwest Realty was born with the knowledge and blessing of the Treasury Department.

We had applied for and received a private ruling from the Treasury Department that our MLP would be treated for Federal income tax purposes as a partnership. The ruling was issued on the basis of certain stated facts, one of which was our tradeability and liquidity.

Without the ruling, we and others who followed us probably would not have ventured onto Wall Street.

The second most important factor behind our rollup was the ability of Southwest Realty to raise capital, additional capital, that its predecessor partnerships were unable to raise.

In fact, subsequent to completion of the rollup, we raised a substantial amount of additional equity capital through a public offering of our depositary receipts. The proceeds of the offering were used primarily to retire existing debt.

The third and perhaps the most important factor inherent in our decision to use an MLP format—was our desire to basically control our own destiny. In that regard we looked very closely at other forms of business entities that we could have chosen, including and perhaps especially REITs.

Mr. Vander Jagt earlier asked whether there were substantive differences between an MLP and a REIT for real estate entities, and I can unequivocally say yes. Some of them include: control, separate management requirements of a REIT, the requirement of a REIT to distribute a minimum amount of income, whether or not the income is passive, and the possible or potential problem of phantom income, the prohibition against reinvesting certain gains and the questions involving active and passive income, to name a few.

In addition, we have heard a number of questions raised by the panel regarding the argument that an MLP walks and talks like a duck so it must be taxed as a corporation. Contrary to what Mr.
Mentz said earlier, there are substantive differences between an MLP and a corporation.

I have discussed many of those in my submission, which I would like to be placed in the record, please.

In addition, I would like to mention two differences in particular, the first of which is the control issue, and I believe that it is more traditional in partnership format to have the general partners or general partner in control of management with very little provision to replace that management.

There are so-called democracy provisions applicable to MLP's, but they are substantively different, for the most part, from the democracy provisions applicable to corporations.

The second difference I would like to mention is that of liability. There are two parts to that liability issue. The first part is the general partner. Under partnership law you must have a responsible—a financially, economically responsible general partner to whom creditors can turn.

There is no such requirement with a corporation. If the corporation gets into trouble, you take its assets and that is it. There is no one else to look to. That is inherently not the case in an MLP or in any partnership format.

In addition, Mr. Cain mentioned that there is a certain amount of potential liability to the limited partners that you don't have in the corporation format. That liability specifically has to do with the obligation of limited partners-investors to return distributions to the partnership if the partnership improperly made a distribution and there were insufficient funds remaining with which to pay creditors.

I would like to also mention in passing that not only did we have a Treasury private ruling that said that we would be treated as a limited partnership, but I was here back in 1983 testifying before the Senate Finance Committee on the same exact issue, and at that time there was a hue and cry in the papers and in the press and a serious concern in 1983 that we were going to have a disincorporation of America, and I seem to have been defending it ever since.

It hasn't happened. Four and a half years later we still have approximately 100 master limited partnerships, hardly what I would call the disincorporation of America.

In closing, I find myself in the unfortunate position of having to disagree somewhat with one of my colleagues who spoke earlier today, and agreeing in part with Mr. Mentz. I find that a little surprising. Nonetheless, I believe, contrary to the position taken earlier by one of the panelists that we should tax all MLPs the same. If in fact we end up with a disincorporation problem or it becomes more real than apparent, there is always time to do something about it.

I don't think we should make any distinction, tax wise between any form of MLP, be it in real estate, energy or in any other business.

I would like to note that back in February 1984 in testimony before the House Ways and Means Committee at hearings on tax shelters, accounting abuses and corporate and securities reforms, there was a statement made on behalf of Mercedes-Benz by its then outside counsel, J. Roger Mentz, who was concerned about a pro-
posal to limit tax benefits on automobiles. He stated "If you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory."

If you are bound and determined to achieve a legislative solution on passthrough entities, please do it in a way that is nondiscriminatory and treat all master limited partnerships the same, and in the same manner as you treat all other partnerships.

[The statement of Mr. Sandler follows:]
TESTIMONY
of
LEWIS H. SANDLER
on behalf of the
NATIONAL APARTMENT ASSOCIATION

Mr. Chairman and Members of the Select Committee:

Thank you for inviting me to appear before this Select Committee on behalf of the National Apartment Association and Southwest Realty, Ltd., a publicly traded ("Master") limited partnership engaged in the ownership and operation of income-producing real estate, primarily multi-family housing units in the southwest. I am personally, in my individual capacity, one of the general partners of Southwest Realty.

In addition to tax and pure economic considerations surrounding the proposal to treat certain partnerships as corporations for tax purposes, the National Apartment Association is concerned about the potentially adverse impact on the multi-family housing industry that such proposal, if enacted, would engender. Specifically, the primary source of equity capital for new construction of multi-family housing units throughout the country has traditionally been the large partnership format. Multi-family housing still requires sources of equity capital to assure a continuing source of rental housing. The proposal under consideration would eliminate one of the primary sources of readily available equity capital at affordable prices.

Southwest Realty commenced operations and trading of depositary receipts representing the economic attributes of its limited partnership interests in February 1983. Southwest Realty was created through a so-called "roll-up" of 14 existing limited partnerships, each owning its own cash flowing, income-producing property in which my two partners and I were already the general partners. There were three major considerations behind our roll-up. None of them were tax-related.

The first and foremost consideration was liquidity. Prior to February 1983, we were not able to offer our limited partner investors an opportunity to sell or hypothecate their limited partnership interests. Nor were these investors able to effectively utilize their illiquid partnership investments in their estate planning. Prior to the advent of MLPs, traditional investment partnerships did not enjoy liquidity. That has changed today with the listing for trading of some (currently still fewer than 100) limited partnerships and the creation of other investment vehicles designed to acquire limited partnership interests in existing (otherwise illiquid) limited partnerships.

Our Liquidity, by the way, was born with the knowledge and blessings of the Treasury Department. We applied for and received a private ruling from the Treasury Department that our MLP would be treated for federal income tax purposes as a partnership. The ruling was issued on the basis of certain facts, including the anticipated listing of our depositary receipts for trading on a national exchange. Without such ruling we, and others who followed in our footsteps, would not have ventured onto Wall Street.

Today we are still a limited partnership. We are still engaged in the ownership and operation of substantially the same income producing real estate that we owned and operated in 1982 when we obtained the ruling. We are trading regularly in an orderly market. We continue to file tax returns and issue K-1's to our investors. Nothing has changed. Today, however, we hear that we would be treated for tax purposes as a corporation. I submit that such treatment is inequitable and unnecessary.
We have deprived the government of no revenue. We do not market our depositary receipts on the basis of tax advantages. In fact, to the best of our knowledge, the investing public has never paid a penny for the tax aspects of our MLP; rather, we believe that they have purchased the depositary receipts because of the yield or underlying value of the assets. This is probably true of most of this MLP's in the marketplace, although there are a few that are basically service-oriented and appear to trade on the basis of their earnings, actual or potential.

The second most important factor behind our roll-up was the ability of Southwest Realty to raise capital - additional capital that its predecessor partnerships were unable to raise. In fact, subsequent to the completion of the roll-up, we raised a substantial amount of additional capital in the form of equity through a public offering of our depositary receipts. The proceeds from this offering were used primarily to retire existing debt.

Although generally, an MLP has the ability to issue additional equity or debt, we are one of the other MLP's that have found that in industries such as real estate, the ability to raise additional capital, especially in the form of equity, is more readily available and the cost is more economic, than trying to raise additional debt. In the Southwest where our multi-family housing projects are located, market conditions today do not lend themselves readily to new debt issues. In fact, the newspapers are full of articles regarding the inability of existing income producing real estate to meet their current debt obligations. For some, the ability to raise additional capital in the form of equity may be the means for survival.

A third factor important to and inherent in an MLP is management's control of its own destiny. Frankly, when we were considering our roll-up, we considered and rejected the corporate format because we had no desire to go to the trouble and expense of forming an MLP only to have it taken over by corporate raiders.

Traditionally, a limited partnership structure includes no readily available mechanism for a change in management. Prospective investors of limited partnership interests are generally aware that they are buying a management team and that in the absence of malfeasance it is difficult at best, to replace that team. A review of most of the MLP's that have come to market in the last four years leads me to believe that the control issue is a dominant factor in the sponsor's determination to adopt a partnership format. That is not to say that minimum so-called "democracy" requirements are not observed. I believe that they are but at far less expense to the equity investors.

Having described Southwest Realty's individual situation, I would like to address the "corporate characteristics" issue, particularly the idea that size and tradeability are appropriate criteria for determining tax treatment. It appears that much of the interest in changing the tax treatment of publicly traded limited partnerships has been generated by a belief that these entities so closely resemble corporations that equity compels it. This resemblance is superficial, however, based almost entirely on size and public trading. These elements are not determinative criteria under current law, and I feel that they should not be under any new system of classification that Congress or Treasury might adopt.

Under the current classification regulations, known as the Kinzer regulations, a partnership is defined as any unincorporated organization which carries on a trade, business, financial operations, or venture. The organization will be treated as a taxable association rather than a partnership for tax purposes if it is composed of associates who have an objective to carry on a business or financial enterprise and divide the gains and also possesses at least three of the four "corporate" characteristics: 1) continuity of life; 2) centralization of management, 3) limited liability, and 4) free transferability of interests.

Publicly traded limited partnerships have been classified as partnerships by the IRS because they do not possess more than two of the four characteristics. While it is generally conceded that publicly traded limited partnership possess centralized management, and of course their interests are freely traded, they do not possess continuity of life and
limited liability. Those who would focus on tradeability as the determining criterion, therefore, would be greatly magnifying the importance of a characteristic which for the past twenty-seven years has—quite correctly—been only one of four equally weighted criteria.

One of the considerations before you today is whether the Kintner regulations need reworking. If that is done, I urge that you avoid the temptation to make size and tradeability the primary criteria for distinguishing partnerships from corporations.

In the first place, public trading has never been in fact a determinative or even significant characteristic of corporate status. The stock of some 98% of all corporations is not publicly traded. Furthermore, the use of public trading as a determinative factor poses real definitional problems. Markets are now developing for syndicated partnership interests. Some of these markets are exchanges; others are not. Some are regulated; others are not. Tradeability is an artificial and inappropriate criterion for deciding whether a partnership ought to be treated as a corporation for tax purposes. It is an external characteristic that has little to do with the intrinsic nature of an organization and its business activities.

In connection with the issue of tradeability, I refer you to a statement made to the Senate Finance Committee on October 24, 1983 by the then Deputy Assistant Secretary for Tax Policy, Department of the Treasury. Speaking on behalf of the Treasury Department against a proposal to treat publicly-traded limited partnerships as corporations for tax purposes, Mr. Pearlman stated "...we have serious doubt that after such an analysis, one would conclude that the degree of marketability of an organization's equity interest should determine the manner in which the organization is taxed." I concur with Treasury's position as so stated by Mr. Pearlman.

For similar reasons, the use of size as a determinant is equally inappropriate. Many syndicated, non-traded partnerships are as large as or larger than many publicly traded partnerships. Many corporations are far smaller—the majority have less than one million dollars in net worth. The number of participants in an organization or the size of its business assets is simply not a valid or relevant criterion for determining federal tax classification.

These criteria are inappropriate not only because they are inaccurate, but because they create a conflict with state partnership laws (generally the Uniform Limited Partnership Act or Revised Uniform Limited Partnership Act), which treat publicly traded limited partnerships as partnerships rather than corporations, and because they ignore several differences between publicly traded partnerships and corporations that are far more significant than size and tradeability. These differences, which tend to work to the disadvantage of partnerships, are important both to an individual's investment decision and the taxpayer's decision as to which form of business to adopt. They include:

**Liability:** A noted above, MLPs, like other partnerships do not offer investors completely unlimited liability. The assets of at least one general partner in an MLP must be reachable by creditors. In addition, the limited partners may also be liable to the partnership's creditors in certain cases, e.g., when there has been a distribution of capital to the partner prior to the time the liability arose. This is a significant disincentive to investors.

**Perpetuity:** Also as noted above, corporations are perpetual in nature, while publicly traded partnerships, like all partnerships, are for a fixed term of years and may be terminated by any one of several occurrences.
Taxation on undistributed income: Unlike corporate shareholders, partners in a publicly traded partnership are taxed on their share of partnership income whether or not cash is distributed to them. This is a disincentive to investors and, because it puts pressure on the MLP to maintain high cash distributions rather than to retain and reinvest earnings, a major disincentive for business owners.

Limits on institutional investors: Institutional investors such as tax-exempt pension funds, universities, and private foundations are a major source of capital for corporations. Various state and federal laws, however, restrict the ability of these institutions to invest in publicly traded limited partnerships.

State law: As noted above, publicly traded limited partnerships operate under state partnership, rather than corporate, law. The fact that state partnership law is less comprehensive and less settled than corporate law is another disincentive to business owners.

An entity level tax has been imposed on corporations at least partially as payment for the benefits they receive from incorporation. And ever since the income tax was first imposed, businesses have been able to make the tradeoff. They have been able to choose whether to enjoy the benefits of incorporation and pay a corporate tax in return or to forego these benefits along with the tax. I see no reason why either size or public trading should be enough to deny businesses this choice.

In short, when you examine the question of classification and pass-through entities, I urge that you resist the temptation to impose a standard that would base entity level taxation on factors such as size or public trading which have little to do with the form in which businesses have chosen to operate. I understand the appeal of these criteria; they appear on the surface to be simple and easy to apply. But one thing that I am sure you have learned in the process of tax reform is that simplicity can often work against logic and equity.

The fact that an MLP is large and publicly traded does not mean that it enjoys the benefits of incorporation and should pay for them through a corporate tax. In fact, MLPs enjoy very few of the advantages that corporations do. That is why they are still less than one percent of the capital market. To impose a corporate tax on them would not serve the cause of equity. It would, in fact, do just the opposite. As a businessman and the general partner of an MLP, I ask that you continue to allow us to choose for ourselves which benefits and burdens are the best ones for our companies to assume.

In closing I would like to leave you with a statement made in February 1984 before the House Ways and Means Committee at Hearings on Tax Shelters, Accounting Abuses and Corporate and Securities Reforms. The statement was made on behalf of Mercedes-Benz by its then outside counsel, J. Roger Mentz, who was concerned about a proposal to limit tax benefits on passenger automobiles used for business purposes to the first $15,000 of cost. Mr. Mentz stated "To the extent that there is a personal benefit problem with automobiles, it exists for all business automobiles, not just those priced over $15,000. ... if you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory." Continuing with Mr. Mentz's analogy, if you are bound and determined to achieve a legislative solution on pass-through entities, do it in a way that is nondiscriminatory and treat Master Limited Partnership in the same manner as you treat all partnerships.

Please leave us with our liquidity and sources of equity capital. The multi-family housing industry and Southwest Reality, Ltd. urge you to maintain the existing tax treatment for master limited partnerships. Thank you for your time and consideration.

Very truly yours,

SOUTHWEST REALTY, LTD.

By:  
Lewis H. Sandler
General Partner
Mrs. Kennelly. Thank you.
I am going to adjourn the hearing for ten minutes and I will be back after I vote at 20 after.
[Recess.]
Mrs. Kennelly. The hearing will continue with testimony by Mr. Rosenthal.

STATEMENT OF JEFFREY R. ROSENTHAL, MEMBER, SUBCOMMITTEE ON FEDERAL TAXATION, NATIONAL ASSOCIATION OF REALTORS, AND CHAIRMAN, TAX COMMITTEE, REAL ESTATE SECURITIES AND SYNDICATION INSTITUTION

Mr. Rosenthal. Thank you.
I am Jeffrey R. Rosenthal. I am a partner in the Chicago office of Peat, Marwick, Main & Co. I am testifying on behalf of the National Association of Realtors, and its affiliate, RESSI. The NAR is an umbrella organization consisting of approximately 750,000 members with interests in all types of real estate activities.
RESSI represents approximately 3,000 members who specialize in investment in income-producing real estate and mortgage loans, as well as the creation and issuance of real estate securities. Many of these real estate securities are designed to attract investment from middle-income investors, by offering relatively low-cost investment units which would not otherwise be affordable to those people.

Our primary recommendation to this subcommittee is that the tax treatment of limited partnerships as pass-through entities should be maintained, including the tax treatment of master limited partnerships, MLPs. An MLP should be defined as a limited partnership having equity securities which are both publicly offered and traded. A more explicit definition is included in my written testimony. Such securities are hereinafter called listed securities.

The tax treatment of partnerships, including MLPs, should be maintained because it is a proven capital formation technique, particularly for middle-income taxpayers. Some MLPs have been designed to appeal to wage earners with annual incomes as low as $25,000. We feel that any limitation on capital formation, and particularly one aimed at limiting low risk, diversified investments to middle-income taxpayers, would be an undesirable effect of this subcommittee’s recommendations.

In addition, the 1986 Tax Reform Act eliminated the perceived abuses which were previously associated with tax preferences, but which were not directly attributable to pass-through entities.

Consequently, entity classification rules designed to eliminate or limit pass-through entities are not warranted. The Treasury Department and the Joint Committee on Taxation have proposed to reclassify such entities as corporations, by subjecting them to either the corporate tax or the corporate minimum tax or by subjecting their investors to certain aspects of the corporate minimum tax.

Each of these proposals improperly attacks the limited partnership as the cause of tax abuse and is inappropriate because the perceived tax abuses have been eliminated and attacks on pass-through entities improperly focus on a distribution vehicle within a now neutral tax code. Therefore, reclassification proposals would
achieve little, while disrupting an important source of capital formation.

A major reason for investment in MLPs and other limited partnerships is to raise equity capital to reduce or retire debt or to acquire unleveraged real estate. This is in direct response to the anti-debt policy of the Tax Reform Act of 1986. The use of equity financing on partnership properties increases the investors' cash flows through reduced debt service.

This is also coincident with the 1986 tax reform goal of economically motivated investment decisions. In addition, debt reduction has the effect of reducing the exposure to foreclosure of many troubled financial institutions by reducing the loan to value ratios on overfinanced properties.

Thus, the elimination of a capital formation vehicle which provides additional funds to many unstable financial institutions would also be an undesirable effect of any such proposal if approved by this committee.

Although RESSI and NAR believe that the present tax treatment of MLPs and other limited partnerships is appropriate, we feel even more strongly that the current treatment of real estate MLPs and other limited partnerships predominantly investing in real estate should be retained.

Corporation taxation of real estate MLPs and other partnerships can only be characterized as a new tax increase levied on real estate, and not as an attempt to preserve the corporate revenue base, as some, including the Treasury, have claimed.

The limited partnership was the traditional investment vehicle for investment real estate before tax reform and has continued since. No significant portion of investment real estate has ever been within the corporate tax base and the idea that MLPs and other limited partnerships are removing investment real estate from the corporate tax base should be regarded as a misconception.

Treasury statistics released yesterday indicate that a significant proportion of MLPs formed in 1986 and 1987 as a result of liquidations and rollouts, the so-called disincorporation problem. Most of those rollouts relating to real estate entities involve real estate developed for sale rather than investment. In addition, last year's repeal of the General Utilities Doctrine now assesses tax on the removal of these assets from the corporate tax base.

Consequently, corporate classification of MLPs and other limited partnerships owning investment real estate would constitute a new tax on investment real estate, in addition to the estimated $50 to $60 billion that was assessed, we feel disproportionately, in the 1986 Tax Reform Act.

Finally, we oppose the Treasury's proposals for withholding at the partnership level. This proposal improperly shifts the self-compliance burden from the taxpayer to the partnership. Further, the inexact nature of such withholding would create as much administrative burden as the Treasury feels it would eliminate, due to new reporting requirements at both the partnership and partner levels.

In summary, we recommend that this subcommittee retain the tax treatment of MLPs and other limited partnerships. We stand in opposition to proposals to subject limited partnerships to the corpo-
rate tax or corporate minimum tax or to subject limited partners to certain aspects of the corporate minimum tax.

Further, we think that proposals to withhold tax at the limited partnership level are inappropriate and ineffective with respect to reducing administrative burden.

Thank you.

Mrs. Kennelly. Thank you, Mr. Rosenthal.

[The statement of Mr. Rosenthal follows:]
Statement of Jeffrey R. Rosenthal, National Association of Realtors

My name is Jeff Rosenthal. I am a partner in the Chicago office of Peat, Marwick, Main & Co. I am testifying on behalf of the NATIONAL ASSOCIATION OF REALTORS® and the Real Estate Securities and Syndication Institute (RESSI), which is an affiliate of the REALTORS® organization. The NATIONAL ASSOCIATION OF REALTORS® is an umbrella organization consisting of 750,000 members with interests that span the breadth of real estate activities, including the ownership, operation, management, development, appraisal, and sale of single family residences and commercial real estate, including both residential and non-residential structures. RESSI represents 3,000 individuals and corporate members who specialize in investment and management of income-producing real estate and mortgage loans as well as the creation, issuance, analysis, and management of real estate securities. The group real estate investment programs in which these individuals are involved range from relatively small private placements of undeveloped land to multi-million dollar group real estate investment programs involving large real estate complexes. Many of the offerings in the post-tax reform era are designed to attract middle-income investors by offering units priced between $1,000-$5,000 for investment opportunities in diversified mortgage loans and/or the ownership of rental real estate.

My statement is organized and presented in the following manner. First, I shall summarize the recommendations that RESSI and the NATIONAL ASSOCIATION OF REALTORS® would like this Subcommittee and the Congress as a whole to consider in its tax reform efforts. Secondly, I shall discuss in detail the reasons underlying our contention that the current tax treatment of both limited partnerships generally and of limited partnerships which own or make mortgage loans on rental real estate are appropriate and should be maintained. Thirdly, I shall respond to suggestions appearing in recent publications and articles arguing for the creation of a model pass-through entity to replace the partnership as an investment vehicle for real estate. And finally, I have prepared an analysis of recent suggestions that the entity classification rules should be replaced with a new standard that accentuates the importance of the limited liability test to the exclusion of other factors that are currently applied under existing Treasury regulations.

I. Summary of Recommendations to this Subcommittee:

A. The tax treatment of limited partnerships as a pass-through entity under present law should be maintained, including the tax treatment of Master Limited Partnerships (MLPs). A Master Limited Partnership or MLP is defined as a limited partnership (formed pursuant to the laws of any state) having equity securities which are registered under the Securities Act of 1933 and are either (i) traded on a national securities exchange registered under the Securities Exchange Act of 1934 or (ii) designated as national market system securities under the Securities Exchange Act of 1934. The Securities and regulations adopted thereunder. Such securities are hereinafter called "Listed Securities." Simply stated, an MLP is a partnership that has been publicly offered and has Listed Securities.

The tax treatment of partnerships, including MLPs, should be maintained as an effective capital formation technique to attract investor capital and particularly middle-income investor capital. As the ensuing discussion more clearly indicates, MLPs have been designed to appeal to wage-earners with annual incomes as low as $25,000 by offering Listed Securities priced between $1,000 to $5,000. Moreover, passage of the 1986 Tax Reform Act has adequately addressed any perceived abuses that may have previously existed. Revisions to the tax rules concerning entity classification, including partnerships and MLPs, are not warranted. If Congress makes a determination, as some have suggested, that the Internal Revenue Code of 1986 should not be reopened for a period of time in order to fairly evaluate the effects of the last two Tax Reform Bills on the nation’s economy, then this rationale should also apply to the present tax treatment of Master Limited Partnerships.

B. Although RESSI and the NATIONAL ASSOCIATION OF REALTORS® believe that the present tax treatment of MLPs as a partnership is appropriate, we feel very strongly that the current treatment of MLPs predominantly owning rental...
real estate or making mortgage loans on rental real estate should be retained. Otherwise, decisions by the Congress to tax real estate MLPs as corporations can only be characterized as a new tax increase levied on real estate, and not as an attempt to preserve the corporate revenue base, as some have claimed. The limited partnership was the traditional investment vehicle used for the acquisition of rental real estate before the advent of tax reform, and this practice has continued subsequent to the passage of that legislation. Consequently, legislation to terminate the use of MLPs owning investment real estate would constitute a new tax on investment real estate, which would be in addition to the estimated 50 to 60 billion dollars over a five year period that was assessed on investment real estate in the 1986 Tax Reform Act.

C. If the Congress acts to curb the use of MLPs, including MLPs that principally own rental real estate and/or make mortgage loans on rental real estate, any proposed restrictions should apply only to MLPs as defined above. Any proposal passed by Congress reclassifying MLPs for tax purposes should nevertheless continue to permit partnership taxation for limited partnerships which are either publicly offered or non-publicly offered and do not have Listed Securities. Any proposal to restrict MLPs that limits the use of limited partnerships that do not have Listed Securities and are formed to invest in real estate would deal a crippling blow to investment real estate, thereby reducing the yield from such investments through imposition of the corporate tax. Moreover, the costs to the economy and to the real estate industry of another significant amount of investment real estate would be quite damaging in terms of higher unemployment for the construction industry, which is only now coming to grips with the adverse effects of tax reform. A new tax would also have an especially harsh effect on a capital-intensive industry, such as real estate, with a concommitantly detrimental impact on this country’s GNP to which real estate contributes roughly 40% annually.

D. If the Congress decides to consolidate all pass-through entities, such as limited partnerships, RICs, REMICs, or REITs, into a model pass-through entity that would more closely resemble a REIT, as some have suggested, then many of the restrictions governing the qualification test and the asset investment rules currently applicable to REITs must be relaxed in order to provide the entity with the flexibility (which REITs currently lack and that partnerships possess) that is essential to meet the diverse needs of today's investors in real estate market. It should be noted that Congress recognized this need for flexibility in certain real estate investments when it adopted the REMIC as an investment vehicle for mortgage-backed securities.

II. REASONS IN SUPPORT OF RECOMMENDATIONS

A. A Proposal to Tax Real Estate MLPs as Corporations Cannot Be Justified as Necessary to Preserve the Corporate Revenue Base. But Instead Represents a New Tax on Investment Real Estate.

Because investment real estate was held in limited partnership form before the passage of the Tax Reform Act of 1986 and continues to be held primarily through limited partnerships, a proposal of a legislative or regulatory nature to classify limited partnerships with predominantly real estate interests as corporations for tax purposes would represent a new, substantial tax increase on the real estate industry. Investments in rental real estate were never a significant part of the corporate revenue base before passage of tax reform and has remained outside of the corporate revenue base after its enactment. Thus, efforts to tax real estate MLPs as corporations and not as partnerships for tax purposes cannot be justified on the grounds that such actions are necessary to preserve the corporate revenue base.

A new tax on real estate in the form of taxing real estate MLPs as corporations for tax purposes would be in addition to the estimated 50 to 60 billion dollar tax increase which the real estate industry paid for the individual and corporate rate reductions contained in the Tax Reform Act of 1986. These tax increases consist of a combination of various provisions, including: the passive loss limitation that limits the deductibility of passive losses to the income from passive activities, which is defined by
statute to include rental real estate; restrictive investment interest rules which significantly limit the deductibility of interest incurred to purchase investment assets, including real estate; reduced depreciation deductions for structures; revisions to the at risk rules; less generous tax incentives for the rehabilitation of historic structures and older buildings; and less attractive tax-exempt bond financing rules pertaining to multi-family housing, among others. The point to emphasize is that the real estate industry, and especially investment real estate, paid a disproportionate share of the tax increases contained in the Tax Reform Act of 1986 to achieve the tax rate reductions for individuals and corporations.

Although it can be argued that legislation to restrict the use of MLPs may be warranted in those instances where an active trade or business disincorporates or chooses the partnership vehicle simply to escape the corporate tax, this rationale cannot be cited as authority for taxing a limited partnership that owns investment real estate as a corporation. Group ownership of and mortgage loans on rental real estate have traditionally not been made through a limited partnership and this practice remains unaffected by tax reform. Moreover, the repeal in the Tax Reform Act of 1986 of the General Utilities doctrine, which allowed tax-free corporate liquidations, now predominantly causes the costs in additional taxes of liquidating a corporation to be more expensive than the savings achieved through avoidance of double taxation. The reasons for the use of the limited partnership by the real estate industry are diverse, including both tax and non-tax factors. The major tax reason for the selection of a limited partnership as the principal investment vehicle for real estate is the flow-through nature of a partnership for tax purposes. Under the law that existed prior to the Tax Reform Act of 1986, the partnership vehicle provided partners with the ability to apply their pro rata share of tax losses from the partnership investment against other income on their individual tax return and to pay only a single tax on any taxable income of the partnership. After tax reform, which repealed tax incentives for real estate, the most popular investment vehicle for rental real estate remains the partnership, due to the existence not only of only a single tax on partnership income, but also in response to the new rules imposed on real estate investments by tax reform.

In recent years, a new, larger publicly-offered, partnership having Listed Securities called the Master Limited Partnership (MLP) as defined above has been utilized to attract investment in a wide range of activities, including oil and gas, real estate, and other investments. MLPs provide the opportunity for diversification of investments to middle-income, smaller investors who have previously been denied access to the breadth of investment possibilities available to wealthier investors. MLPs are to be contrasted with other limited partnerships (including publicly offered partnerships), that do not have Listed Securities. MLPs began to be used in late 1984 and have grown in popularity in the last few years. The reasons for the surge in MLP activity vary with the nature of the industry and the type of investment involved. In the case of investment real estate, the MLP has gained prominence as a means of attracting equity capital to acquire, or construct, large residential and commercial facilities that otherwise would be beyond the reach of the middle-income investor.

A second major reason for the development of MLPs is to use the equity capital provided by investors to reduce or retire the outstanding indebtedness on existing partnership properties or to acquire unleveraged or low-leveraged real estate. Use of the MLP to acquire rental real estate with less leverage or to retire existing indebtedness on rental properties is in direct response to the anti-debt policy of the Tax Reform Act of 1986. Of particular importance is the fact that MLPs that own rental real estate do not pose a threat to the corporate tax revenue base. Whether or not the partnership is an MLP that represents a roll-up or a consolidation of existing rental properties or the acquisition of new properties, rental real estate was previously and currently is owned by limited partnerships in the vast majority of group investment situations.

Moreover, the use of investors' equity capital to buy new properties without leverage or with low leverage or to reduce the outstanding indebtedness on partnership properties in real estate MLPs allows the investor to obtain a higher yield by improving the cash flow of the partnership through reduced debt service. In the present investment climate, industry officials believe that a 10% to 12% annual yield is necessary to compete with alternative forms of investment and that such a return cannot be attained without significant debt reduction or retirement. Typically, real estate
investments without the tax incentives of prior law and with substantial indebtedness on the properties would have achieved an initial yield of 6%, which would make them uncompetitive with...
limited partnerships that do not have Listed Securities. The reasons for this position are listed below:

First, if the Congress decides to tax MLPs as corporations because the interests of MLPs are Listed Securities, this rationale does not apply to interests in limited partnerships that do not have Listed Securities. Interests in limited partnerships that do not have Listed Securities are not liquid and are subject to numerous restrictions on their transferability. In 1986, for example, less than one percent of the units in public or non-public limited partnerships, which do not have Listed Securities, were sold for value. In many cases, a limited partner who wishes to sell his interest in a partnership must obtain the consent of and grant the right of first refusal to the general partner. Moreover, often a transferee must meet an original investor's suitability requirements and/or obtain regulatory approval. In short, an investment in a publicly-registered limited partnership contrasts sharply with an interest in an MLP based on the liquidity or lack thereof of the investment.

Secondly, imposition of a corporate tax on publicly-registered limited partnerships would reduce the yield from investments to such a degree that use of the partnership as an investment vehicle would be inappropriate in most instances. Yet, the limited partnership is the only investment vehicle currently available under our present tax system with sufficient flexibility to attract investor capital, especially middle income investors, in the post-tax reform era. A recent article in The Wall Street Journal (June 11, 1987) correctly observed that public partnerships are presently being offered in small denominations, such as $1,000, in order to attract middle income investor capital to the market. Many investors have annual incomes as low as $25,000. The article further points out that the real estate acquisitions being made by such partnerships are of a low-risk, low-leveraged variety, because middle-income investors cannot afford to take undue risks. Once again, the growth of real estate limited partnerships that offer the small investor the opportunity to obtain a high yield from an investment realizes the goal of Congress in the 1986 Tax Reform Act to encourage economically-sound transactions. Furthermore, such partnerships offer the investor the ability to invest in major projects, such as apartments, shopping centers, hotels, commercial office buildings, resort communities, and other real estate investments of a magnitude that would be unavailable to the investor without group investment. In addition, the article observed that non-public, private placement offerings which are generally offered to wealthy investors in real estate have declined precipitously since passage of the tax reform bill. Private placement offerings tended to be those that provided investors with substantial tax benefits which are no longer available after tax reform. Specifically, The Stanger Report projects total private partnerships sales of roughly $1.5 billion for all of 1987, which is a substantial decline from the $3.5 billion in private placement capital raised in 1986.

C. The Partnership is the Sole Investment Vehicle with the Flexibility to Meet the Diverse Needs of Real Estate Investors. Developers, Lenders, and Borrowers.

Flexibility has always been the hallmark of the partnership as an investment vehicle that distinguished it from other forms of investment. The partnership as an investment vehicle provides optimal flexibility to meet the diverse needs of a wide range of investors in a sophisticated real estate market. To illustrate, in a typical real estate transaction, a priority distribution of a specified amount can be provided to a person or entity contributing substantial capital to the development of a real estate project, while another investor can receive a higher percentage of cash flow remaining in excess of the priority distribution. A permanent lender may receive a percentage of the economic appreciation on the sale of the property. The general partner may receive a percentage of the economic appreciation on the sale of the project subordinated to a specified return to investors and may also receive a different percentage of the cash flow during the operation of the property. These allocations are also important for economic, non-tax reasons, because they provide a means for incentive compensation to developers and others active in the real estate business. This degree of flexibility is unattainable with any other alternative form of investment vehicle.

What this example illustrates is that neither a corporation nor a REIT can vary the percentage of ownership for each equity owner in different items of income, loss, gain, and cash distributions while a partnership possesses the
ability to alter allocations of income, loss, gain, and cash distributions, to meet the needs of various participants to a real estate transaction. While special allocations of income and loss have tax ramifications that produce different tax results for various partners to a partnership transaction, the recently finalized regulations under Section 704(b) mandate that such allocations must have substantial economic effect if they are to be recognized for tax purposes. Consequently, the potential for abuse of the tax laws under the special allocation provisions of the Federal income tax laws are negated to a large degree. The important point to emphasize is that special allocations are utilized in a partnership agreement, especially in the post-tax reform era, primarily to meet the business needs of the parties and not to achieve tax objectives.

D. Imposition of a corporate tax on real estate limited partnerships that do not have Listed Securities would discourage group investment in rental real estate by drastically reducing the yield from such investments.

Information furnished by the industry indicates that partnerships specializing in real estate have prospered during 1987, because the real estate industry responded to the impact of tax reform by structuring transactions to meet the needs of today's investors. Real estate limited partnerships are raising equity capital from investors to acquire additional properties or to retire or reduce existing debt. Thus, real estate offerings have moved away from the traditional use of leveraging and high debt financing to a market in which equity capital or low leverage furnishes much of the resources necessary for the development or acquisition of rental properties. Moreover, continuing the trend that began after passage of the 1984 tax bill, the real estate industry has offered the investor, through use of the real estate limited partnership, a viable entity that provides the potential for significant cash flow and economic appreciation by reducing the debt service on existing properties and financing the purchase and construction of new properties. By the attraction of investor equity or low leveraged capital, as well as through a reduction of various fees charged by the promoter and syndicator, the real estate industry has been able in recent years to provide more attractive yields to investors on rental real estate investments, which make real estate competitive in the marketplace with alternative choices.

However, imposition of a corporate tax on the cash flow of a real estate investment from a limited partnership that does not have Listed Securities would reduce the yield from the investment to such a degree that a real estate investment would no longer be competitive with other investment possibilities. This is especially true for retirement plans which represent a growing segment of the real estate investment market. Statistically, the share of equity capital provided by retirement plans, especially small retirement plans, has risen at an increasing rate over the last several years. As pension fund offerings expanded, so did new non-tax-exempt entities, investments by pension managers are made on the basis of annual yield and economic appreciation and not because of tax incentives. In 1986, more than 60% of the $8.4 billion raised in equity capital through public offerings of real estate limited partnerships, was funded by retirement plans, whereas the percentage of equity capital furnished by such plans in 1982 was only 50%.

An even more positive development for the real estate investment market in recent years has been the tendency of retirement plans, especially the smaller plans, to diversify their investment portfolio by placing a higher percentage of their assets in real estate. Previously, asset managers for retirement plans generally followed a conservative investment policy that directed plan assets primarily into stocks and bonds. ERISA encourages retirement plans to diversify their assets, which should appropriately include investments in real estate. The group real estate investment industry has created limited partnership investment opportunities to enable retirement plans to invest in real estate. Recent studies have shown that a more diversified investment plan for retirement plans, including a higher percentage of investment in real estate assets, would have produced a significantly higher yield for retirement beneficiaries than their actual investment decisions produced. For example, during the eleven year period from 1972 through 1982, the financial return for real estate investments was 11% in comparison to 7.7% for common stocks. The yield to retirees and pension beneficiaries would have increased to 8.5% from 7.7% if the institutional managers of pension funds had invested 20% of their assets in real estate and only 80% in common stock as opposed to the actual percentage of only 3% or less invested in real estate during that same period.
However, the current trend for retirement plans, especially smaller plans, to invest more resources in limited partnerships that do not have Listed Securities would quickly be reversed if a corporate tax is levied on the income of such partnerships. If that eventuality were to occur, payment of the corporate tax would consume too much of the cash flow from the real estate investments made through the partnership to allow such investors to be competitive with alternative choices available to individual retirement accounts or pension managers for retirement plans, whose primary responsibility is to achieve a yield sufficient to meet the retirement income needs of their beneficiaries. In fact, many pension managers would escrow investments in real estate limited partnerships that were reclassified as corporations for tax purposes simply because the corporate tax was imposed, irrespective of the economics of the transaction or the amount of the tax. Thus, the movement by pension managers towards diversification of the investment portfolio would be brought to a screeching halt, which would be to the detriment of the overall yield attained by retirement income beneficiaries and to the further dismay of the real estate industry. Moreover, not only would the yield from real estate investments made by limited partnerships be drastically lowered by reason of the imposition of a corporate tax, but the economic appreciation of interests in real estate limited partnerships that do not have Listed Securities would be reduced by reason of the lower income stream available to investors.

E. If the Congress decides to adopt a model pass-through entity for all types of investments, in lieu of all existing pass-through entities, including the limited partnership, then the model pass-through entity must contain the flexibility which partnerships possess under current law.

During its consideration of the proper tax treatment to be accorded pass-through entities under the federal income tax system, if the Congress decides to consolidate all pass-through entities, including limited partnerships, RICs, REITs, and REMICs, into a single, model pass-through entity, then we would recommend that such an entity be granted the flexibility which the partnership possesses and which the other investment vehicles, the REIT, the corporation, and the S corporation, lack.

Under present law, a partnership agreement can be drafted with the flexibility necessary to meet the individual needs of particular partners. The flexibility to adopt these features is not present under existing law in either a REIT, a RIC, a REMIC, an S corporation, or an ordinary corporation. In order to make the REIT a more attractive vehicle for real estate investment, substantial revisions are required to the rules governing both the qualification of REITs and the investment of REIT assets in addition to the changes made to the REIT rules in the 1986 Tax Reform Act. If additional changes are made to the REIT provisions allowing for this flexibility, then such a hypothetical REIT would approximate the tax treatment of limited partnerships, which limits the distributions of partnership income and activities to the income from such investments. Certainly, one change that should be immediately adopted is to treat the income distributed by a REIT as passive income instead of as portfolio income which is presently the case. This revision would merely conform the character of income from a REIT to that of income from a limited partnership owning rental real estate. However, if these changes are not made, then the REIT as an investment vehicle is too inflexible to attract anything but a small percentage of the total investment capital currently invested in rental real estate. In the absence of a viable investment vehicle to meet the needs of today's real estate investor, the implications for the real estate industry would be ominous.

Even more significant revisions would be required to cause the corporation to be an attractive investment vehicle for rental real estate. Apart from the adverse feature of double taxation, the corporation can only offer common or preferred stock to its shareholders or debentures to its lenders. A corporation does not possess the flexibility to provide different shareholders with varying percentages in different layers of income and losses associated with corporate assets. If the S Corporation is chosen to be a candidate for a model pass-through entity, then its rules must also be substantially revised. These revisions would be in addition to the changes made in the 1982 legislation regarding S Corporations. Current rules allowing S corporation status only where a corporation has 35 or fewer shareholders must be relaxed. Additional revisions that would be required to make S Corporations a suitable vehicle for real estate investment include revisions to the basis rules governing the basis that a shareholder in an S Corporation has in his stock.
and the rules must also be overhauled regarding the percentage of passive income that an S Corporation can have without disqualification. A further drawback to the use of an S corporation as an alternative to a limited partnership for real estate investment is the fact that many states, including California, do not recognize the existence of an S corporation under their state income tax laws. In those states, the effect is that the income of the S corporation is subject to the state corporate income tax, which substantially reduces the yield in those states.

F. Comments on Suggested Revisions to the Entity Classification Rules

Recently, there have been a number of proposals to revise the rules governing the appropriate classification of an entity, including a limited partnership, under the Federal Income tax laws.

Under Treasury Regulations, (Section 301.7701-3), partnerships are distinguished from corporations by determining whether four corporate characteristics apply to the entity in question. These corporate characteristics are continuity of life, centralized management, limited liability, and free transferability of interests. Under these rules, an entity is taxed as a partnership for tax purposes if it possesses no more than two of these attributes absent other factors indicating corporate classification. If an entity possesses more than two of these characteristics, it is taxed as a corporation.

In one such article, it was suggested that the entity classification rules be revised to include only one criterion, which would require an entity to pass a vastly expanded test of unlimited liability in order to warrant classification as a partnership for tax purposes. These suggested revisions to the characteristic of limited liability would cause an entity to be taxed as a corporation, whether or not the business was conducted in partnership form, if either the partnership did not have general partners with a net worth (excluding the value of partnership property) at least equal to the outstanding liabilities of the partnership or if less than a substantial amount of the partnership liabilities are not on a recourse basis for which a partner(s) has personal liability. If both tests are met, the entity would be taxed as a partnership, but only the general partners with exposure to liability would be allocated the tax losses of the partnership.

This approach, if implemented, would cause serious disruption to investment real estate and would raise more questions than it answers.

First, if the general partner must have a net worth at least equal to the amount of partnership liabilities without taking into account the value of the underlying collateral, then virtually no real estate partnership would be taxed as a partnership. Few, if any, general partners in real estate developments have sufficient net worth to equal the amount of outstanding partnership debt without regard to the value of partnership property. Moreover, it is inequitable to assume that the partnership assets have no value in determining whether one or more partners have a net worth adequate to cover partnership debt. In addition, if the net worth of one or more partners must equal the amount of debt incurred by a partnership owning rental real estate in order for the partnership to avoid the corporate tax, then why should such a test be applied only to partnerships? Would such a test also require individual owners to have a net worth equal to the amount of debt on the rental property to avoid corporate taxation without including the value of the property?

Secondly, even if one or more general partners has a net worth equal to partnership liabilities excluding the value of partnership property, the proposed test would tax the partnership as a corporation if more than an insubstantial amount of the partnership debt were nonrecourse in nature. Such an approach would cause a drastic overhaul of the prevailing use by lenders of nonrecourse financing on both residential and nonresidential rental properties. In the typical situation, a construction loan for the development of rental real estate will be a recourse loan for the simple reason that collateral does not exist to reassure lenders until construction is completed. When the structure is placed in service, the permanent lender provides a nonrecourse loan to take out the construction lender and secure repayment of the loan with the property. It should be noted that lenders who arrange nonrecourse loans do not do so to further the tax objectives of the borrower, but because they have collateral in the structure that equals or exceeds the outstanding debt owed them by the borrower. Moreover, many
states, including California, mandate the use of nonrecourse financing in a number of real estate transactions. Furthermore, the question must be asked, if the presence of a significant amount of nonrecourse indebtedness on partnership property causes the partnership to be taxed as a corporation, why should this test not also be applied to individual owners of rental property, causing them to be subject to the corporate tax, if their property is financed with a nonrecourse loan.

And finally, the proposal would require partnership tax losses to be allocated exclusively to those partners with unlimited liability even if the net worth and recourse liability tests were met. This aspect of the proposal would require a substantial rewriting of the special allocation provisions of Section 704(b) of present law. Treasury regulations, which were recently finalized under Section 704(b), require substantial economic effort in order for allocations of income and loss that are contrary to the general profit and loss ratio to be respected for tax purposes. Most tax experts believe that the final regulations address the potential abuses of noneconomic, tax-motivated allocations under prior law. Also, the proposal only suggests that tax losses be allocated to partners bearing the risk of loss, but does not discuss the allocation of income. Would income follow loss allocations for tax purposes or would it be allocated under a different formula? Moreover, such a proposal would be contrary to the widely accepted view reflected in the 704(b) regulations that those investors who may lose capital in a transaction should be entitled to a deductible loss from their economic investments.

CONCLUSION

To summarize, both RESSI and the NATIONAL ASSOCIATION OF REALTORS® strongly believe that the present entity classification rules should not be changed and that the current tax treatment of partnerships, including MLPs, should be maintained. The Tax Reform Act of 1986, which repealed or greatly curtailed tax incentives for real estate investment, has adequately addressed any perceived tax abuses. Revisions to the entity classification rules are unnecessary and would be a case of overkill at a time when the real estate industry is adapting to the effects of tax reform.

If Congress is of a different view, we urge you to target the perceived abuses only and not to adopt a sweeping proposal that could have devastating effects on the real estate industry, which already is in a period of transition after tax reform. RESSI and the NATIONAL ASSOCIATION OF REALTORS® stand ready to work with the tax-writing Committees of Congress in drafting appropriate legislation, or to answer any questions that you may have.
MRS. KENNELLY. Mr. Lee, you mentioned that material participation is an important criteria that this committee should address. Do you think that is more important than whether the business conducted by the organization is an active business that traditionally has been a corporation?

Mr. Lee. I think those are two different questions. First is in terms of an entity versus aggregate approach, material participation is the question. In terms of now we have something that the people don't materially participate in and therefore it has to be an entity, at that point when we determine whether we can have a passthrough and, if we do, what level of taxation is carried, only the active business/passive investor should be carrying this corporate sector tax I have been talking about.

If it is passive business/passive investor, then it should be a separate entity, but should probably be able to pass through at the regular individual rates, much like an S corporation is what it would look like.

But if the enterprise is active business/passive investor, then in 1986 you decided that it carry, say $220 billion; and we can't let that type of active business/passive investors go into a different plastic wrapping and not carry that burden.

So it is both.

MRS. KENNELLY. Would you agree, Mr. Wilson?

Mr. Wilson. My comment revolves around the inequity of taxing a partnership because you bring in public unit holders and it is patently unfair, just because in our case we have sold some of our units to individual unit holders, that the whole partnership should be taxed.

However, I think that there is a position—this morning there was some question raised by someone—I can't remember who it was, one of the Congressmen—concerning how to get around this question.

I would think that the following would probably be a solution, while it is not an acceptable solution to everyone—I would think that a partnership should not be taxed as a corporation just because it has a public shareholder, but when it decides to make a decision to sell shares to the public, when it makes that threshold decision, they have to consider that the distributions are going to be portfolio distributions as opposed to the possibility of them being considered otherwise.

Now, the Treasury has this power now—this Congress gave the Treasury that kind of power and, in my opinion, that might be a place where it can be applied, in other words, to warn all the people in the industry, when you decide to sell public units of a partnership, you are automatically going to be considered to be portfolio income.

When that is known, then that decision will be made and taken into account before they go public.

But I just believe that what we are considering now is wrong. I will liken it to this. Loopholes for taxing are just as bad as loopholes for not taxing. What is being considered right now is creating a loophole for taxing a particular entity because a public unit holder has bought a share of the unit. It just defies logic as to why that is equitable, why it is fair.
However, another alternative is once the enterprise is public, its distribution is then portfolio income. I think there might be merits to that. I personally think that there is a lot more merit to that than what we are considering right now.

Mrs. Kennelly. Maybe I could ask Mr. Sandler or Mr. Wilson to comment on another suggestion by Professor Lee that single tax treatment should only be allowed to organizations in which investors materially participate in a venture.

I think you suggested, Mr. Lee—

Mrs. Kennelly [continuing]. That a single tax treatment should only be allowed to organizations in which investors materially participate.

Mr. Lee. What I said was aggregate, which means you are treating the partner or the shareholder as if they own the underlying property and automatically pass it through. That should only apply when you materially participate.

If you do not materially participate, there could be a single tax. But the framework would be like Secretary Mentz suggested a year ago, that all S’s and K’s be taxed, all subchapter S’s and partnerships, be taxed much like subchapter S’s.

That would be Treasury’s model that would be available if you did materially participate. You would be more like an S corporation, even if you were a partnership.

The next question becomes: Do we, if you are a separate entity, allow you to pass through, and that would be under $100,000, sure, no problem. Over $100,000 we begin to get into the corporate sector area and, if you are going to allow them to pass through, it could be a single tax but not a single tax at 28 percent, the individual rate, on an eroded corporate tax base. It would have to be 28 percent on economic income or, say, 45 percent on the eroded base.

Mrs. Kennelly. I was going to ask Mr. Sandler and Mr. Wilson, aren’t we complicating this to such an extent that we have done away with people making the decision anyway?

Mr. Sandler. I think that the distinction—we are trying to make a distinction between who are the active or passive investors in a partnership format. Academically it may be sound, but I think as a practical matter it would be very difficult to determine.

I have been a general partner in small partnerships where we had ten investors. I am now individually a general partner in a master limited partnership where we have thousands of investors. The little old man or little old lady who has her 100,000 shares or depositary receipts in Southwest Realty takes a very active interest in the management of our business and doesn’t hesitate to call and tell us what to do. To the contrary, the large investor, when I had a partnership in which we had ten large, very sophisticated investors, tended not to take an active role.

So although it sounds good, I don’t know how you would make that determination—certainly not on size, because I think that is artificial, just as I think it is artificial as to what kind of business the entity is engaged in. You should treat all partnerships the same, whether they are in one kind of business or the other, all partnerships the same regardless of the number of people in them.

Mrs. Kennelly. You agree with Mr. Wilson on that?
Mr. Sandler. Yes.

Mrs. Kennelly. Mr. Wilson?

Mr. Wilson. I would like to point out something. We are in the home-building, land development, building of apartments and so forth. Somebody this morning raised the question about a level playing field.

Mrs. Kennelly. They always do.

Mr. Wilson. I would like to point out that in our industry the majority of home builders pay taxes at one level. That may come as news to this committee, but generally speaking home builders are two or three individuals owning a corporation.

I have built homes for 30 years. I would be out of my mind to do it any other way. So we are building homes in subchapter S corporations. Too, we are building them in partnerships that are closely held and closely controlled, one level of tax. The public companies that we compete with, they represent maybe 10 or 15 percent of the total home building capacity of the country.

So, in effect, 80 to 85 percent of the revenue derived from home building is probably singly taxed. Now we are a partnership that is involved in that business, and I see no reason why we should inherently be classified with a couple of public corporations that are clearly paying corporate tax and require because they are paying corporate tax because of home building, that we as a partnership should pay, whereas the partnership I am competing against, which is closely held, is not.

In other words, there is not now a uniform playing field and there never was.

The question now becomes: Why tax this partnership because it has a couple of public holders? That is bad tax policy, in my opinion, and I am saying, in effect, that the threshold should not be whether the public shareholders are involved or not, it should be just a general presumption that when you become a public partnership, at that point in time the income becomes portfolio income, and that solves that problem. And those partnerships that want to become public also know that is the threshold question.

In our case we would not have done it, but in the future those who are going to do it, they will know that is one of the decisions to be considered.

I just think it is bad policy at this point to put us in a position of having issues shares to public unit holders after 2 years of hearings and that we are going to put them in a position where they are going to lose part of their investment.

The stock is dropping just because of the public disclosure of this hearing. If there is a move to pass this kind of what I call discriminatory legislation, it is going to drop the value significantly more.

The only one that got hurt is the public. I am not going to get hurt because we will become a private partnership the day after the law is effective. As far as the revenue the Treasury will get, put a line through it. We won’t be there.

Mrs. Kennelly. Partnership level withholding to ensure compliance, is there some way that we can calm the worries of Treasury that we are going to have this hemorrhaging—is there something we can do now?
You have a success story. What could we look at to do to get some revenue—we have compliance.

Mr. Wilson. With due respect to your intent, and I appreciate what you are saying, it has been my experience that the agencies of Government charged with the responsibility of carrying out the congressional intent are always looking for some easy way to do their job.

It seems to me right now that they have a problem of collecting taxes from stockholders who have stock in street names, who have them in corporations, who have them hidden away.

They have the problem of trying to track a dividend from those sources and they have been working on it for a number of years by having the reporting system on dividends and so forth.

It so happens that because of the focus of Treasury on partnerships, we are under the microscope, and I would suggest right now that if anything is true, we probably have more of an attempt to control that phantom that the Treasury raises than any single industry. In other words, the partnerships are probably going to do a better job of seeing to it that the taxes are paid by its unit holders than stockholders in corporations.

Now, if that does not work, after thirty years of appearing before congressional committees, the one thing I know for sure is these issues never die. If it does not work, I am sure we will be back in 24 months saying let's have a change, and I would be testifying we didn't do the job, let's change it, have withholding.

But I would think right now, having just put in a new law on January 1 and having a hearing today without having a chance to see if that which we did January 1 is working is really the wrong way to go about solving this problem.

I don't think that we ought to discriminate against a partnership unit holder as opposed to a stockholder in any other corporation at this point until we are sure that there is, in fact, a problem.

Mrs. Kennelly. I heard almost immediately after we finished tax reform for 1986, the buzz—if you have been around the Hill, you know how quick the word goes. Immediately I heard that this passive loss limit is fine and good. If you form a partnership you can get around it and it won't hurt the real estate industry, they in fact can adjust. How do you answer that, because I think that is why you have developed so quickly.

Mr. Wilson. I live in Middleburg and I operate out of Washington and I agree with you, as soon as you leave this room there will be some discussion on how to get around whatever it is you raise. That is the American system of business. Thank God for it. That is what keeps us on top, and I would have to say there is nothing wrong with that until it is abused, and when it is abused I know the Congress knows how to take action on that, such as you did in the real estate industry.

I supported the changes in the real estate because there was massive abuse. I am not one that says that you start taking action on a perceived threat before you know the threat to be real. The problem we have right now is that everybody is right but at different times.

The Treasury was absolutely right last year. There is no doubt that we were going to reorganize America’s business into partner-
ships, had the Congress, your committee, not taken effective action on two very important points. Those points were the General Utilities doctrine, which clearly it makes no sense for a corporation to pay a liquidation tax, pay another tax at the stockholder level in order to put into a partnership.

As a matter of fact, I proposed the following theory: In some respects, if you want to balance your budget, reverse that and you probably will balance the budget in the next 2 years because clearly it will be a massive conversion, there is no doubt. But you did take care of that.

Unfortunately the conversations I hear are by people who listened to it last summer, not realizing that the two major changes that you made effectively will prevent it.

As you know, there is always someone who doesn’t get the word. Having attended the hearings last year, there are an awful lot of people who have massive conversion in their mind. They think that the MLP income is a tremendous tax source. It is not. And they don’t realize it because they don’t have the facts.

As a matter of fact, the Treasury doesn’t have the facts. They are proposing it and they don’t even have the facts. Very interesting. They are saying there is a lot of money to be had on doing this but they don’t really know for sure, and when they put it together, a good portion of that income that they are talking about is the classification of portfolio versus passive, and I am saying to you in advance that if that issue is resolved for the public partnerships, and distributions is automatically classified portfolio income, then the Treasury’s numbers drop from $600 million down to maybe $100 or $50 or maybe nothing—a very interesting proposition, and they have the tools to do that.

Mrs. KENNELLY. Who has the tools to do that?

Mr. WILSON. The Treasury has the tools to do that. You gave them broad authority, almost gave them carte blanche on qualifying partnership income as portfolio income and not just public, but even private partnerships, which is the proper way to go.

Mrs. KENNELLY. Thank you.

I have been dying to hear the answer to that question myself, and I appreciate it.

Mr. Sandler?

Mr. SANDLER. I was just about to take some issue on whether Congress’ authority was quite that broad.

I think that is somewhat debatable as to whether Treasury can simply classify whatever it wants to as portfolio income. The issue of whether it should be portfolio income or not is really not before us now, although if that comes before us I am sure we would have a lot to say about it.

Mr. ROSENTHAL. With respect to the questions you have asked, the first had to do with whether or not material participation should be a factor in determining at one level or another of Professor Lee’s comments, whether or not you should have an entity taxed as an entity or as a passthrough entity.

I think that there are a number of problems with that. First of all, defining material participation was something that you and the Congress had an awfully hard time with just last year. I could ask any of the members of your committee, any of the members of the
Senate Finance Committee, to define that and I am not sure that they could—

Mrs. KENNELLY. I am sure Mr. Dorgan could.

Mr. ROSENTHAL. Maybe he could. I will bet I could disagree with him. I don’t think that that is a standard that would work.

Further, the definition of “participation” in each and every industry is different. It is not a workable solution, and for that reason I can’t see the link to how you decide whether you tax an entity or whether you don’t.

With respect to your question on withholding, I am opposed to that because I don’t think it achieves the purpose that it is alleged to achieve, getting more compliance. There are a number of issues relative to compliance, one of which that is clearly important is the complexity involved with compliance.

There are a lot of problems with taxpayer compliance in this country, simply because they don’t know what to do with the information that they have. A lot of people think that compliance is just the so-called underground economy where no tax is paid.

There is a problem where taxpayers just cannot process their own tax returns. Adding withholding to a partnership K-1, which is admittedly complicated, would not achieve any more purpose than the problems that it would create. You would have taxpayers deducting the taxes thinking that it is a dividend, some type of deduction that is passed through to them, others picking it up as income because they think it is equivalent to a dividend.

Consequently, I don’t think that the withholding would do a particular amount of good.

Mrs. KENNELLY. Thank you.

Thank you all for excellent testimony and thank you very much for coming.

The hearing is adjourned.

[Whereupon, at 1:50 p.m. the hearing was adjourned.]

[Submissions for the record follow:]