1988

Pass-Through Entities as Investment Vehicles

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THIRTY-FOURTH WILLIAM & MARY TAX CONFERENCE

Williamsburg, Virginia

December 2-3, 1988

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Interest in the use of pass-through entities for investment has been heightened by the 1986 Tax Reform Act (the "1986 Act"), particularly by:

1. Repeal of General Utilities doctrine, and

2. Substantial reduction in individual tax rates when compared to corporate rates.

I. LIMITED PARTNERSHIPS AND S CORPORATIONS

A. In General

Limited partnerships and S corporations have substantial advantages over most other conduit vehicles (e.g., pass-through of losses, preservation of character of income at entity level). Their principal limitation as compared to those other vehicles is generally a lack of liquidity.

B. Limited Partnerships v. S Corporations

Limited partnerships are usually more appropriate vehicles for investment than S corporations. The principal advantage of an S corporation over the limited partnership form is limited liability. The advantages of limited partnerships over S corporations include the following:

1. No limitations on the number or types of investors.

2. Many states do not recognize S corporation

status and therefore impose corporate income or franchise taxes.

3. Flexibility in permitting various classes of equity.

4. Ability to include entity level debt in basis of partners, which may permit pass-through of losses and distribution of excess refinancing proceeds primarily in the case of real estate investments.

5. See Announcement 88-118, Rev. Proc. 88-44 and Rev. Rul. 88-76, Internal Revenue Bulletin 1988-38, September 19, 1988 for liberalization of rules concerning the use of sole corporate general partners.

II. MASTER LIMITED PARTNERSHIPS

A. In General

The term Master Limited Partnership generally refers to a conventional limited partnership, the interests of which are publicly traded. Its principal appeal, subject to the Revenue Act of 1987 (the "87 Act"), is the elimination of the second level of taxation imposed on the use of a corporate vehicle while maintaining a similar access to public markets that have long existed for corporate entities. Note, however, that tax exempts are generally subject to UBT on their distributive shares of partnership business income. Anticipating this trend, Congress enacted legislation in 1986 and 1987 to limit the appeal of MLPs.

B. Basic Statutory Scheme

Publicly Traded Partnerships ("PTPs") are defined in terms of the public marketability of interests. The 87 Act creates a bifurcated system for the tax treatment of PTPs. In general, with the exception of PTPs that meet certain transitional tests (which delay their treatment under the general rule until 1998) and, in the case of PTPs meeting certain income requirements, PTPs are treated as associations taxable as corporations. PTPs excepted from the general rule will continue to be taxed as pass-through entities but with the income being treated akin to portfolio income for passive loss purposes and unshelterable by investment interest, the losses otherwise available being limited for use against future income from that PTP and with tax exempt entities being required to include their distributive shares of PTP income in their unrelated business taxable income base ("UBTI"). See Code Section 469(k).

C. PTP Definition and Two Tier System

1. Definition.

Code Section 7704(b) determines a partnership to be a PTP if its interests are traded on an established securities market or are readily tradeable on a secondary market or the equivalent thereof. While there are obvious ambiguities in the scope of this definition, it is apparently intended to be broadly interpreted. See 1987 Act, Conference Committee Report at 947.

2. <u>Transitional Exception for "Existing Partnership"</u>

Association treatment is delayed until 1998 for an "existing partnership", i.e., one that was either publicly traded on December 17, 1987 or had filed by that date with the SEC to be publicly traded or had filed by that date with a state agency to restructure a portion of a corporation as a PTP.

3. <u>Passive Income Exception</u>.

Permanently excepted from the general rule is a PTP where 90% or more of its gross income for a taxable year consists of "qualifying income".

Qualifying income generally includes interest, dividends, rents from real property and gain from the disposition of real property, capital assets held for the production of otherwise qualifying income and income from the exploration, mining, production, processing, marketing, etc. of natural resources. A special exception exists to prevent disqualification in the event of an inadvertant failure to meet the income requirement.

III. REGULATED INVESTMENT COMPANIES

A. <u>Definition - Code Sections 851-855, 860</u>

A Regulated Investment Company is an electing domestic corporation registered with the S.E.C. under the Investment Company Act of 1940 as a unit investment trust, management company or business development company, provided it meets certain requirements concerning the sources of its income and the diversity of its asset portfolio. It is the typical format for a mutual fund.

1. Ninety percent or more of its gross income must come from interest, dividends, payments on securities loans and gains from the disposition of stock, securities and foreign currencies as well as other income derived from the business of investment in such stocks, securities and currencies.

2. Less than thirty percent of its gross income can come from gains from the disposition of stock and securities held for less than three months.

3. Asset diversity requirements must be met at the close of each quarter and include the following:

(i) at least fifty percent of the value of total assets are invested in cash, cash items, government securities, securities of other Regulated Investment Companies and other securities representing no more than five percent per issuer of the RIC portfolio;

(ii) not more than twenty-five percent of the value of total assets are invested in the securities of any one issuer (other than Regulated Investment Companies or government securities).

B. <u>Ninety Percent Test - Code Section 852(a)(1)</u>

An otherwise qualifying Regulated Investment Company will not be eligible for conduit status unless the

Regulated Investment Company's dividends paid deduction (other than capital gain dividends) equals at least ninety percent of the sum of its investment company taxable income (without regard to the dividends paid deduction) and ninety percent of its tax exempt income.

C. <u>Taxation of a Regulated Investment Company</u>

An electing Regulated Investment Company meeting all of the requirements discussed above is generally taxed on the same basis as a regular corporation, including the ability to take the dividends paid deduction. It may also deduct any capital gains dividends paid from its otherwise taxable long-term capital gains (taxable at the alternative corporate capital gains rate). Certain other adjustments are made to its tax base (e.g., no NOL deduction, no dividends received deduction).

D. <u>Tax Exempt Interest</u>

A Regulated Investment Company may exclude Section 103 tax exempt interest in computing its taxable income, but such exempt interest is taken into account for purposes of the ninety percent and thirty percent gross income tests as well as the ninety percent distribution test described above. A Regulated Investment Company with at least half its assets consisting of Code Section 103 obligations may also pass through the exempt character of this interest to its shareholders through "exempt interest dividends".

E. Taxation of Shareholders

Non-liquidating distributions not designated as capital gain or exempt interest dividends will be taxed to the shareholders under Sections 301 and 316, i.e., as dividends to the extent of current or accumulated earnings and profits, as tax-free reductions in basis thereafter with excess distributions above basis taxable as gain from the sale of the stock. Capital gains dividends and exempt interest dividends retain their respective character in the hands of the shareholders.

IV. REAL ESTATE INVESTMENT TRUSTS

A. Definition and Structure

A REIT is a domestic corporation, trust or association taxable as a corporation which meets certain requirements concerning the nature of its income and assets, and distributions. Code Section 856. The REIT provisions are organized similarly to the RIC provisions, providing substantial elimination of double taxation through the allowance of a dividends paid deduction.

B. Ownership

Interest must be transferable and must be held by 100 or more persons. No more than 50% of its interests can be owned by 5 or fewer individuals.

C. Sources of Income: 75% Test and 95% Test

In general, at least 75% of a REIT's gross income must be derived from:

1. real property rents
2. mortgage interest
3. gain from non-inventory real estate
4. distributions from other REITs and gains from sales of REIT interests
5. real property tax refunds and abatements
6. income from foreclosed properties
7. commitment fees
8. gain from the sale of certain real estate assets that are excluded from the prohibited transaction rules. Code Section857(b)(6).

In addition, 95% of the REIT's gross income must come from the sources listed above, plus other interest and dividend income or gains from the sale of stock and securities.

D. <u>Asset Test</u>

Seventy-five percent or more of the REIT's total assets must consist of real estate assets (i.e., real property and interest therein, interest in mortgages and shares in other REITs), government securities and cash and equivalent items.

E. <u>1986 Act</u>

REITs, having been patterned after RICs, had been viewed as highly restrictive for use in the real estate industry. The 1986 Act made a number of amendments to the REIT provisions designed to facilitate their use, including creating certain temporary exceptions from the income and asset tests described above, permitting the use of wholly owned subsidiaries to limit liability and diluting some of the passivity requirements.

F. Distributions

In general, a REIT must distribute as dividends an amount at least equal to 95% of its REIT taxable income (computed without regard to the dividends paid and any capital gains) and 95% of the excess of the REIT's net foreclosure income over the tax imposed thereon by Code Section 857(b)(4)(A), less "excess non-cash income." See Code Section 857(e).

G. Tax Treatment of REITs

An electing and qualifying REIT is not taxed except on its ordinary income or capital gain that is not distributed to its shareholders, Code Sections 11(c)(3), 857(b), on its income from foreclosures, on excess unqualified income and on gains from certain inventory sales and certain preference items. Undistributed ordinary income and capital gain income is taxable at regular corporate rates. REITs may carry forward net operating losses and net capital losses.

H. Taxation of Shareholders

As in the case of RICs, REITs may designate capital gains distributions for pass-through treatment, and ordinary distributions are taxable to shareholders as dividends to the extent of current or accumulated earnings and profits.

Excess distributions first represent tax-free reductions in basis and then are taxed as gain from the sale of stock. Dividends are generally not taxable to tax exempt organizations. Dividend distributions to corporate shareholders are not eligible for the dividends received deduction.