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ENTITY CLASSIFICATION AND INTEGRATION: PUBLICLY TRADED PARTNERSHIPS, PERSONAL SERVICE CORPORATIONS, AND THE TAX LEGISLATIVE PROCESS

*John W. Lee**

I. INTRODUCTION

The first wave of revisions to the Internal Revenue Code of 1986 ("the 1986 Code") has occurred, in the form of the tax provisions of the Omnibus Budget Reconciliation Act of 1987 ("OBRA").¹ As with the various revisions to the Internal Revenue Code of 1954, politics continued to play an important role in determining which reforms took place, but politics and policy resulted in the development of revisions to the 1986 Code which broke with the traditional 1954 Code type of reform. The new breed of reform seems to be at least partly based on the policy of using a deep structure entity analysis² to classify organizations for tax purposes and to determine the tax treatment of the entity and its owners. The study of OBRA's provisions in the "classification" of publicly traded partnerships ("PTPs"³) and application of the passive activity loss ("PAL"⁴) rules to them, as well as the elimination of the benefit of graduated corporate rates⁵ for personal service corporations ("PSCs"⁶), provides a framework for consideration of the deep structure or tax policy of entity classification. The integration of the entity with its owners, the comparison of structural tax revisions under the 1954 and 1986 Codes, and the interplay of politics

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¹ Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 [hereinafter OBRA].

² In other words, determining the tax treatment of a given type of entity through considerations of tax policy, not politics.

³ See I.R.C. § 7704(b) (definition of publicly traded partnership).

⁴ See I.R.C. § 469 (passive activity losses and credits limited).

⁵ See I.R.C. § 11(b), which provides graduated brackets for taxable corporate income: 15% of taxable income up to \$50,000, 25% of taxable income from \$50,000 to \$75,000, and 34% of taxable income in excess of \$75,000.

⁶ See I.R.C. § 448(d)(2).

and policy in OBRA are also well suited to deep structure analysis.

This article will begin with a brief overview of the past and present treatment of PTPs and PSCs and the various congressional and administrative applications (or non-applications) of a deep structure analysis in approaching classification and integration issues. A brief comparison of tax reform under the 1954 and 1986 Codes follows. The OBRA changes to the 1986 Code treatment of PTPs regarding classification and integration will then be discussed in greater detail in Section II. Deficiencies in these provisions as measured against a deep structure analysis ideal will be uncovered and alternatives are suggested which better meet this ideal. Section III follows with a similar discussion of the PAL provisions of OBRA. Section IV looks at the specific congressional rationales for the OBRA changes and whether deep structure analysis actually provided the basis for the changes, and Section V compares tax reform under the 1954 Code with that under the 1986 Code. The article then traces the influence of politics on the tax reform process and the halting development of a deep structure tax policy by various administrations and congressional committees in their drafting of actual legislation during the development of the 1954 and 1986 Codes. Next, the article shows that both policy and politics played roles in the passage of the 1986 Code and later OBRA reforms. These reforms came closer to meeting deep structure policy objectives than did reform under the 1954 Code, but fell short of the ideal, largely due to political influences.

A. *PTPs and PSCs*

Superficially, PTPs and PSCs have little in common other than a concentration of ownership among high income taxpayers⁷ and

⁷ Stock ownership is widespread. Forty-two million individuals owned stock directly in 1983, and an estimated 140 million benefitted from indirect ownership of stock through holding such assets as pensions and life insurance policies. See Hearings on Impact of Corporate Takeovers before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 99th Cong., 1st Sess. 1111-12 (1985) [hereinafter *Corporate Takeover Hearings*] (statement of John Phelan, Jr., Chairman of the New York Stock Exchange). But this wide ownership is thinly spread or in non-accountable hands. Individual stock ownership of large corporations is extremely concentrated in high income taxpayers, see Democratic Staff of the Joint Economic Comm., 99th Cong., 2d Sess., *The Concentration of Wealth in the United States, Trends in the Distribution of Wealth Among American Families 24* (Comm. Print 1986) [hereinafter *Concentration of Wealth*] (as of 1983 top 10% of households owned 89.3% of all personally owned corporate stock); Feldstein, *Imputing*

misplacement on the tax entity continuum^a under the 1954 Code

Corporate Tax Liabilities to Individual Taxpayers, 41 Nat'l Tax J. 37, 50 (1988), with 45% held by institutions, Corporate Takeover Hearings, *supra*, at 313 (Securities and Exchange Commission Staff Report). Stock ownership in general has been concentrated in high income taxpayers for some time. See Hearings on Federal Tax Policy for Economic Growth and Stability before the Subcomm. on Tax Policy of the Joint Comm. on the Economic Report, 84th Cong., 1st Sess. 563 (1955) [hereinafter 1955 Tax Policy Hearings] (statement of Professor Lindner). This is particularly true in the case of closely-held corporations. See Hearings on H.R. 13511 (Revenue Act of 1978) Before the Senate Finance Comm., 95th Cong., 2d Sess. (Part I) 136 (1978) [hereinafter 1978 Senate Hearings] (statement of Secretary of the Treasury Blumenthal). The shift to institutional ownership is more recent. See Corporate Takeover Hearings, *supra*, at 313. Given the high median income of professionals, this pattern should be even stronger in the case of PSCs. The pattern of ownership of PTPs is more difficult to determine due to street names, but other than as to tax-exempt and foreign ownership, PTP ownership probably parallels that of publicly traded corporations. See Hearings on Master Limited Partnerships before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm., 100th Cong., 1st Sess. 168, 172, 198 (1987) [hereinafter 1987 Senate MLP Hearings] (statements of Barry Miller and Lawrence Cohen).

^a The current Federal income tax treatment of different business entities ranges along a continuum. At one end of the continuum are entities, such as sole proprietorships and grantor trusts, whose separate existence is for most purposes ignored.

At the other end are entities, such as subchapter C corporations, that generally are treated as separate persons whose tax liabilities are in addition to and independent of those of their shareholders.

Between these two extremes are entities such as partnerships, trusts, S corporations, regulated investment companies, real estate investment trusts, and cooperatives, the taxation of which reflect both aggregate and separate entity principles.

Along the continuum, significant differences in tax treatment include, first, whether the income earned by the entity is taxed to the entity in full, only to the extent not distributed to the owners, or not at all; second, whether the entity's owners are taxed on distributed or undistributed income of the entity; third, whether losses incurred by the entity can be deducted currently by its owners, or only upon a disposition of their interests in the entity; and fourth, whether the timing or character of any income of the entity that is passed through to the owners is altered when passed through.

Hearings on H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448 (Issues Relating to Passthrough Entities) before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm., 99th Cong., 2d Sess. 8 (1986) [hereinafter 1986 Passthrough Entity Hearings] (statement of Treasury Assistant Secretary for Tax Policy J. Roger Mentz [hereinafter Mentz]). This "continuum" appears to be based upon Professor Eustice's schemata sketched in Eustice, Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals), 39 Tax L. Rev. 345, 346-47 (1984) [hereinafter Eustice]. This model in the Joint Committee Staff version is now largely incorporated in bits and pieces into the legislative history of the 1986 Act. See S. Rep. No. 313, 99th Cong., 2d Sess. 783-86 (1986) [hereinafter 1986 Senate Report].

The author would further break down the tax entity continuum between the direct and double taxation extremes. Aggregate passthrough treatment is embodied in Subchapter K, the taxation of partnerships and partners. Under an ideal aggregate model the tax rules would treat the partnership as an entity only for reporting, collection and audit purposes, and would treat the partners otherwise as much as possible as direct owners. Subchapter K

and the original 1986 Code. The misplacement of PTPs as pass-through partnerships and PSCs as separate entities with graduated inside corporate rates lower than the owners' outside marginal rates was due to a failure of deep structure analysis. Unfortunately, the common pattern of misplacement continued in the 1987 PSC and PTP changes, which resulted in ad hoc provisions which were also questionable in their technical aspects. Due to politics, these provisions touched only lightly upon the broad policy and revenue issues which needed to be addressed, and appear to be watered-down versions of broad proposals found in the more thorough 1984-85 tax reform studies.

B. Classification

Since the enactment of the 1954 Code, Congress, through its tax committees, and the various administrations, through the Department of the Treasury ("Treasury"), have periodically examined tax

in actuality contains an aggregate core with optional entity features. See *infra* notes 125-126. Entity passthrough treatment is embodied in current Subchapter S. Income, and to a lesser extent, losses of an S corporation pass through to shareholders in the aggregate manner. See I.R.C. §§ 1366(a),(d). As a concomitant, investment and undistributed earnings, reduced for allocable share of losses, may be withdrawn tax-free. See I.R.C. §§ 1367(a)(1),(2), 1368(b)(1). But in all other aspects, such as allocations and distributions of appreciated property, the non-inclusion of "inside" entity liabilities in an S corporation shareholder's outside stock basis, and transfers of interest, the S corporation is treated as a separate entity. See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., *Taxation of Master Limited Partnerships 11* (1987) [hereinafter *MLP Hearing Pamphlet*]. Entity-conduit treatment applies to RICs and REITs. Separate entity prevails as to all aspects (including deferral of loss until disposal of the interest) except for limited income integration through a dividend deduction for earnings distributed more or less on a current basis and passthrough of capital gain character. See Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *Federal Income Tax Treatment of Pass-Through Entities (Including a Description of H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448)* 10-12, 17-18 (Comm. Print 1986) [hereinafter *Passthrough Entity Hearing Pamphlet*]. Until recently, entity conduit tax treatment comported more closely with deep structure-based policy than that of the other entities. Entity features prevailed because the owners were passive, yet integration of income (but not loss, because the owners are passive) derived from the absence of an active business. See *id.* at 17-18. In the REMIC provisions of the 1986 Code, Congress departed from this policy. See *infra* note 147.

Prior to OBRA, PTPs were treated as partnerships and PSCs as separate entities, despite the fact that the owners of PTPs typically do not actively or materially participate in the entity's business and the owners of PSCs typically do materially participate. Material participation should be the criterion for aggregate treatment and the absence of material participation the criterion for separate entity treatment. See *infra* notes 134, 143 and accompanying text.

entity classification.⁹ Viewing the alternatives as limited to either a

⁹ In 1960 Treasury promulgated extensive revisions to the classification regulations, Treas. Reg. § 301.7701-1-4, which had remained in essentially the same form since the 1934 Revenue Act revision approved by the Supreme Court in *Morrissey v. Commissioner*, 296 U.S. 344, 354-55 (1935). See Sexton & Osteen, *Classification as a Partnership or as an Association Taxable as a Corporation*, 24 Tulane Tax Inst. 95, 108-122 (1975). In response to a series of taxpayer victories in obtaining corporate tax treatment and, hence, retirement benefits for shareholder-employees then limited to employees, the best known of which is *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), the Service and Treasury promulgated the *Kintner* regulations in 1960. The *Kintner* regulations sought to close the door on professional associations by effectively adopting state law form as to the establishment of legal relationships (no states authorized professional corporations at that time). See Treas. Reg. § 301.7701-1(c) (1960). The regulations also attempted to provide certainty by mechanizing the four corporate factors, see *infra* notes 113-116, and the resemblance test to a "more than test," giving the factors equal weight. See Treas. Reg. § 301.7701-2(a)(3) (1960). The bias toward partnership tax treatment for limited partnerships found in Treas. Reg. § 301.7701-2(b)-(e), and -3(b) (1960), did not arise from a slant against professional corporations, but instead constituted a blind adoption of the Board of Tax Appeals' (predecessor to the Tax Court) formalistic and ill-considered opinion in *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942). See Peel, *Definition of a Partnership: New Suggestions on an Old Issue*, 1979 Wis. L. Rev. 989, 991; Sexton & Osteen, *supra*, at 126-28, 131-32.

State legislators responded to the *Kintner* regulations challenge by authorizing professional corporations, prompting further anti-professional corporation amendments to the 1960 regulations in 1965. These amendments were subsequently rejected as blatantly discriminatory. See *Kurzner v. United States*, 413 F.2d 97, 111-112 (5th Cir. 1969); *United States v. Empey*, 406 F.2d 157, 170 (10th Cir. 1969). In 1970 the Service threw in the towel as to professional corporations, Rev. Rul. 70-101, 1970-1 C.B. 278, and in 1982 Congress affected parity and some rationality in the retirement plan area. See *infra* note 266.

"Once defeat was admitted in the professional area, . . . the Treasury quickly focused its attention on the 'tax shelter' limited partnerships. Unfortunately (for the Treasury), the 1960 regulations, designed to make it easy to qualify as a partnership and difficult to achieve association status, stood as a bar at the threshold of the development of an approach to attack such partnerships." Sexton & Osteen, *supra*, at 137. Actually, the bothersome aspects apparently arose more from a quest for certainty and administrability, a theme consistently followed by Treasury. See *infra* note 117. Consequently, in 1977 the Commissioner issued proposed anti-tax shelter revisions to the association regulations which would have taxed many more limited partnerships as corporations. See Prop. Treas. Reg. § 301.7701-1(b), (c); 42 Fed. Reg. 1038-44 (Jan. 5, 1977); Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U. L. Rev. 408, 410 (1977) ("When the Department of Housing and Urban Development protested that the regulations would cripple its attempts to encourage private investment in low-income housing, the regulations were hastily withdrawn"); N.Y. Times, Jan. 7, 1977 at A-11. See *Withdrawal of Notice of Proposed Rule Making*, 42 Fed. Reg. 1489 (1977). Following withdrawal of the 1977 proposed reclassification amendments, the "Service subsequently indicated in Rev. Rul. 79-106, 1979-1 C.B. 448, that it would follow the *Larson* application of the existing regulations, without examining additional factors." Passthrough Entity Hearing Pamphlet, *supra* note 8, at n.7-8.

After this political failure, Treasury shifted to the legislative forum, with President Carter's 1978 Proposals for Tax Reductions and Reform recommending to Congress "that new limited partnerships with more than 15 limited partners be treated as corporations for

passthrough partnership or a separate entity taxable as a corporation, neither Congress nor Treasury reached a satisfactory resolution of the classification of large limited partnerships with inactive owners, nor did they seriously consider classification of close corporations in which the owners actively participate. These 1954 Code forays were not based on a deep structure classification analysis and no consistent principles were developed for placing organizations on the tax entity continuum.¹⁰ Rather, the classification revisions arose from backdoor administrative attacks, first on retirement plans for entrepreneurs¹¹ and later on tax shelters for the

tax purposes; however, partnerships engaged primarily in housing activities will be excepted from this classification rule." Message from the President, Proposals For Tax Reductions and Reform, H.R. Doc. 283, 95th Cong., 2d Sess. 11 (1978) [hereinafter 1978 President's Proposals]. This provision, like many of President Carter's other substantive anti-shelter provisions, was politically unsuccessful. See *infra* note 344.

In 1983 the Senate Finance Committee Staff released a "Preliminary Staff Report on Subchapter C," which proposed that limited partnerships with publicly traded units "would generally be treated as associations taxable as corporations." Staff of Senate Finance Comm., 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations 80 (Comm. Print 1983) [hereinafter Preliminary Subchapter C Report] (public trading was limited to trading on an established securities market). This provision, like most of the Staff's proposals, was based on an American Law Institute ("ALI") proposal. The Staff reclassification provision generated considerable political heat. See Reform of Corporate Taxation, Hearings Before the Senate Finance Comm., 98th Cong., 1st Sess. 7 (1983) [hereinafter Reform of Corporate Taxation Hearings] (statement of Chairman Dole). Not surprisingly, reclassification was omitted from the 1985 Final Report on Subchapter C, see Staff of Senate Finance Comm., 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985, 72 (Comm. Print 1985), on the rationalization that the 1984 Treasury Proposals would classify all limited partnerships with more than 35 limited partnerships as corporations and would subsume the original publicly traded recommendation; so that further piecemeal classification provisions should await the fate of the pending Treasury Proposals. Nevertheless, the 1985 Staff Subchapter C proposal itself was doomed politically by the tax profession's opposition to its repeal of the *General Utilities* doctrine (*General Utilities & Operating Co. v. Comm'r*, 296 U.S. 200 (1935)), a core provision to Treasury. See Sheppard, *General Utilities Repeal: Of Ostriches and Motherhood*, 30 Tax Notes 491 (Feb. 10, 1986); Reform of Corporate Taxation Hearings, *supra*, at 9-10 (statement of Assistant Secretary of Treasury for Tax Policy Ronald Pearlman).

Ultimately the 1984 Treasury Proposals' numerical reclassification of large limited partnerships (over 35 partners) as corporations, see 2 U.S. Dep't of Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth—General Explanation 147 (1984) [hereinafter 1984 Treasury Proposals], was abandoned by the President in his tax proposals to Congress, The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (1985) [hereinafter 1985 President's Proposals]. See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17.

¹⁰ See *supra* note 8.

¹¹ See *supra* note 9.

wealthy,¹² which both proved to be politically unsuccessful.

In the summer of 1986, shortly after the Senate's passage of the Tax Reform Act of 1986 ("the 1986 Act"),¹³ Representative Rangel, chairman of the House Ways and Means Subcommittee on Select Revenue Measures, held hearings on passthrough entities.¹⁴ The result of the hearings was a new set of mortgage-backed securities provisions, including Real Estate Mortgage Investment Conduits ("REMICs"), as well as other conduit changes.¹⁵ In the summer of 1987, the subcommittee conducted hearings on master limited partnerships ("MLPs"¹⁶), i.e., PTPs, which, together with Senate hearings conducted on the same topic¹⁷ and the earlier House pass-

¹² See supra note 9; Keyser, Publicly Traded Limited Partnerships: The Treasury Fights the Wrong War, 36 Inst. on Oil & Gas Inst. L. & Tax'n 10-1, 10-6 (1985).

¹³ See 1986 Senate Report, supra note 8.

¹⁴ See 1986 Passthrough Entity Hearings, supra note 8.

¹⁵ See I.R.C. §§ 562, 851-855, 4982, 7609 (RICs); §§ 856-859, 4981, 6697 (REITs); §§ 860A-860G, 1272, 6049, 7701 (mortgage backed securities).

¹⁶ Hearings on Tax Treatment of Master Limited Partnerships before the House Ways and Means Subcomm. on Select Revenue Measures, 100th Cong., 1st Sess. (1987) [hereinafter 1987 House MLP Hearings]. The term "master limited partnership" or MLP refers to the two-tier structure of many publicly-traded limited partnerships. See MLP Hearing Pamphlet, supra note 8, at 3-4. Such publicly traded parent limited partnership usually acts as a 99% limited partner of an operating limited partnership; such structure is intended to avoid state blue sky restrictions and having to amend the certificate of limited partnership in numerous states each time units of ownership are transferred. See Turlington & Beeson, Master Limited Partnerships: Current Issues, Techniques and Strategies, in Partnership Taxation 1988—An Advanced Program 211, 221, 227 n.16 (Practicing Law Institute 1988).

The four basic types of PTPs (formed through roll-up, roll-out, acquisition, and liquidation transactions) are as follows:

In a rollup transaction, existing limited partnerships are "rolled up" and consolidated into one larger partnership. In a rollup, the existing partnerships are treated as contributing their assets to the master limited partnership, in exchange for units of the master limited partnership, and then distributing the units to their partners in liquidation. The master limited partnership thereby owns the assets of the pre-existing partnership, and has as its unit holders the partners of the pre-existing partnerships. MLP Hearing Pamphlet, supra note 8, at 24. The Joint Committee on Taxation Staff also defines a "roll-out" as a transaction in which a corporation exchanges assets for an interest in the PTP, typically a general partnership interest. See id. at 21. Limited partnership interests are then sold directly to the public by the PTP, sold by the corporate partner, or distributed to the corporation's shareholders. See id. In an acquisition transaction, the PTP is again managed by the corporate general partner, but the PTP purchases its operating assets from the corporation or a third party. See id. at 23. In a liquidation transaction, a corporation liquidates and the PTP acquires its assets. This transaction is less desirable after the 1986 Act's repeal of the *General Utilities* doctrine. See id. at 23-24; infra note 247.

¹⁷ See 1987 Senate MLP Hearings, supra note 7.

through hearings, spurred the 1987 OBRA PTP changes.¹⁸ These House and Senate hearings, which included the testimony of then Assistant Treasury Secretary for Tax Policy Roger Mentz, and the Joint Committee on Taxation staff pamphlets prepared for the hearings,¹⁹ contain the most thorough congressional and administrative examination of entity classification to date. Unfortunately, politics²⁰ tended to obscure the Treasury's and Joint Committee staff's astute policy analysis,²¹ as was evident in the final legislation.²²

C. Integration

During the 1954 Code era, at roughly the same times as they carried on entity classification studies, the tax writing committees and Treasury also took up the corporate-shareholder integration

¹⁸ See *infra* notes 56-107 and accompanying text.

¹⁹ See MLP Hearing Pamphlet, *supra* note 8; Passthrough Entity Hearing Pamphlet, *supra* note 8.

²⁰ Committee Chairman Rangel frequently reminded those appearing before the Subcommittee on Select Revenue Measures during the 1987 hearings on MLPs that the Subcommittee was seeking a policy discussion. See 1987 House MLP Hearings, *supra* note 16, at 4, 7, 104-106, 205, 247, 291.

²¹ The 1986 Passthrough Entity Hearing Pamphlet, *supra* note 8, detailed the taxation of entities spread across the taxable entity continuum, later incorporated in part of the legislative history of the 1986 Code and OBRA, but more importantly it based classification of active business entities as to both corporations and partnerships on whether the entity acted separately from its owners. See *id.* at 14, 17. The 1987 MLP Hearing Pamphlet set forth details of the tax treatment on the "continuum" even more clearly and classified the subcategories of PTPs. See *supra* note 8. The 1987 Staff analysis is directed at the arguments for and against corporate classification, ultimately coming down in favor of corporate classification. See MLP Hearing Pamphlet, *supra* note 8, at 29-37; H.R. Rep. No. 391, 100th Cong., 1st Sess. 1065-67 (1987) [hereinafter 1987 House Report].

²² Thus, corporate PTPs are taxed more heavily than most publicly traded C corporations. See *infra* note 199 and accompanying text. Passthrough PTPs are treated as aggregates subject to Subchapter K. See *infra* note 283 and accompanying text. Close C corporations (other than PSCs) enjoy graduated Subchapter C rates on retained earnings lower than materially participating owners' marginal rates. See *infra* note 33. Adherence to the Staff's focus on control of the entity or its business would have avoided the legislated errors in the treatment of passthrough PTPs and close corporations. Only separation of the classification as separate entity or aggregate issue from the integration issue, of which the Staff did not conceive, could have avoided the corporate PTP treatment error. Finally, OBRA correctly applied separate entity treatment to passthrough PTP losses, with a complete separate basket approach. See *infra* notes 89, 295 and accompanying text. However, this separate basket approach reveals the policy defect in the general PAL passive gain/passive loss netting rule and results in economic inefficiency. See *infra* note 300 and accompanying text.

issue.²³ Unfortunately, here too the tax committees and Treasury manifested no particular interest in deep structure analysis of the two-tier corporate tax, save in Treasury's 1977 Blueprints for Tax Reform.²⁴ Indeed, on two occasions during the 1954 Code reform

²³ Chairman Wilbur Mills undertook three rounds of hearings on basic tax policy from 1955-1960, following a format of presentations by witnesses, usually followed by questioning from the Chair and on occasion, debates. As to technical substantive areas Chairman Mills appointed advisory groups for reports on Subchapters C, J and K, with hearings on their reports as well. See, e.g., *Hearings on General Revenue Revision before the House Comm. on Ways and Means*, 85th Cong., 2d Sess (Part 3) 2458-3259 (1958) [hereinafter 1958 Mills Hearings]; *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code before the House Ways & Means Comm.*, 86th Cong., 1st Sess. (1959) [hereinafter 1959 Advisory Group Hearings]. Integration, or at least double taxation and responses and capital accumulation in small businesses, was discussed in all three policy proceedings. See 1955 Tax Policy Hearings, *supra* note 7, at 502-12, 520-24, 554-56, 565, 585-92; 1958 Mills Hearings, *supra*, at 57-60, 72-79, 231, 301-03, 327 (1958); Panel Discussion on Income Tax Revision Before the House Comm. on Ways & Means, 86th Cong., 1st Sess. 831-915, 921-939 (1959) [hereinafter 1959 Panel Discussion]. Position papers were presented for the first and third rounds of the Mills Hearings. See Joint Comm. on Economic Growth and Stability, 84th Cong., 1st Sess., *Papers Submitted by Panelists Appearing before the Subcomm. on Tax Policy* (Comm. Print 1955) [hereinafter Tax Policy Papers]; House Comm. on Ways & Means, 86th Cong., 1st Sess., *Tax Revision Compendium* (Comm. Print 1959) [hereinafter Compendium]. An invaluable hearing pamphlet was prepared for the first of these proceedings. Staff of Joint Comm. on the Economic Report, 84th Cong., 1st Sess., *The Federal Revenue System: Facts and Problems* (Comm. Print 1956) (prepared for November 1955 Hearings held by Chairman Mills of the Tax Policy Subcommittee). Mills' studies unfortunately bore little fruit directly. See 131 Cong. Rec. H12,243 (daily ed. Dec. 17, 1985) (statement of Speaker of the House O'Neill); Birnbaum & Murray, *Showdown at Gucci Gulch* 174 (1987).

In 1978 Chairman Al Ullman took up the cry for "integration" after the Carter Administration abandoned it due to the big C corporations' dislike of dividend pay-out incentives. See *Hearings on the President's 1978 Tax Reduction and Reform Proposals before the House Committee on Ways & Means*, 95th Cong., 2d Sess. (Part 1) 94, 95, 102, 486-88 (statement of Secretary of the Treasury Blumenthal), (Part 9) 6144-51 (statement of Professor Graetz) (1978) [hereinafter 1978 House Hearings]; Minarik, *How Tax Reform Came About*, 37 Tax Notes 1359, 1363 (Dec. 28, 1987). Espousal of radical tax changes was thought risky by conventional wisdom ever since the late Chairman Ullman's espousal of a value added tax ("VAT"), which appeared to be the direct cause of his defeat in his next bid for reelection. See Birnbaum & Murray, *supra*, at 194-195; Minarik, *supra*, at 1366.

The Treasury Department undertook a study completed in 1984, 1984 Treasury Proposals, *supra* note 9, some of which eventually made its way into the Tax Reform Act of 1986. See Sunley, *A Summing Up of the 1986 Act; What Happened to Comprehensive Income Taxation?*, 34 Tax Notes 63 (Jan. 5, 1987). However, much of what Treasury recommended was not included in the 1986 Act. For example, the Treasury Proposals advocated more economically realistic depreciation schedules for assets and greater accounting for inflation in not only the figuring of tax brackets, but also depreciation, inventories, and capital gains. See *id.* at 64. Treasury also recommended permitting corporations to deduct fifty percent of dividends paid, see *id.*; neither recommendation was included in the 1986 Act. See *id.*

²⁴ U.S. Dep't of Treasury, *Blueprints for Basic Tax Reform* 64-67 (2d rev. ed. 1984) [here-

process, the administrations then in office simultaneously advocated a limited form of corporate-shareholder integration and treatment of large limited partnerships as regular C corporations,²⁵ an apparent policy conflict noted by those seeking to preserve the status quo.²⁶ The root of this conflict was a desire to encourage capital formation through new equity instead of retained earnings or debt investment,²⁷ rather than deep structure policy, which un-

inafter Blueprints]. The Blueprints, the first edition of which was released late in the Ford administration, called for complete integration of corporate-shareholder taxation with "first-day" imputation as a corollary of a consumption tax and of elimination of the capital gains preference. See also Canellos, *Corporate Tax Integration: By Design or by Default*, 35 Tax Notes 999, 1001 (June 8, 1987).

²⁵ President Carter's administration at one point supported both integration and treatment of limited partnerships with more than fifteen limited partners as corporations. See 1978 House Hearings, *supra* note 23, at 6151 (statement of Professor Graetz), 1978 President's Proposals, *supra* note 9, at 11 (President Carter's reclassification proposal). Similarly, Assistant Secretary Mentz advocated classification of master limited partnerships as corporations in the same administration that earlier had unsuccessfully supported corporate shareholder integration. See 1986 Passthrough Entity Hearings, *supra* note 8, at 10-11 (statement of Mentz).

²⁶ See 1986 Passthrough Entity Hearings, *supra* note 8, at 41 (statement of William McKee). Cf. Keyser, *supra* note 12, at 10-5 (suggesting Subchapter S is more desirable than Subchapter C).

²⁷ Witnesses, particularly economists, frequently maintained throughout the three sets of Mills hearings on tax policy, see *supra* note 23, that the double tax structure encouraged financing from debt and retained earnings. Not surprisingly in the 1955 Tax Policy Hearings, *supra* note 7, at 507, 509, Chairman Mills of the Subcommittee on Tax Policy clearly articulated his interest in integration as producing more equity capital and thereby alleviating the necessity of as much debt financing. At the same time, members of the Subcommittee learned that C corporations were actually used by high income shareholder as inside tax shelters through deferred tax on retained earnings. See *id.* at 526 (statement of Rep. Curtis), 551 (Chairman Mills questioning Dr. Hall), 586 (statement of Dr. Hall). Indeed, in the 1959 Panel Discussions, Chairman Mills pointed out the 1954 Code dividend exclusion provision was enacted "not because of the theory of double taxation so much, nor the question of whether or not corporate [taxes] were shifted or not shifted as much as the thought that this treatment of dividend income might serve as an incentive to the investment in corporate shares." 1959 Panel Discussions, *supra* note 23, at 855. The same purpose motivated the 1978 Integration Proposals. See 1978 House Hearings, *supra* note 23, at 855 (colloquy between Secretary of the Treasury Blumenthal and Chairman Ullman with Ullman stating that "one of our great problems in business is over reliance on debt and under utilization of equity. I think your restoring investment in equity in this country is one of the goals we should try to achieve in order to revitalize our economy.") Similarly, the motivation of the 1984 Treasury Proposals' reduction of taxation of corporate earnings through a fifty percent dividends paid deduction was the encouragement of equity financing over debt financing on economic efficiency grounds. See 1984 Treasury Proposals, *supra* note 9, at 135; Hearings on Tax Aspects of Acquisitions and Mergers before the Subcomm. on Oversight and Subcomm. on Select Revenue Measures of the House Ways & Means Comm., 99th Cong., 1st Sess. 123 (1985) [hereinafter *Acquisitions and Mergers Hearings*] (statement of David Brockway,

doubtedly drove the 1954 and 1986 Code integration studies. This emphasis on capital formation was probably a cause of the lack of deep structure analysis in the classification area as well.

The desirability of close C corporation graduated rates, meant to encourage or subsidize capital formation in small businesses (even if only via increased retained earnings²⁸) was discussed in each integration debate.²⁹ The graduated rates generated the economic inefficiencies³⁰ of horizontal disparity as to businesses conducted in

Chief of Staff of Joint Comm. on Taxation).

²⁸ See 1958 Mills Hearings, *supra* note 23 at 2956-66 (statement of Frazar Wilde, President of Connecticut General Life Insurance Co.), 3027-29, 3032.

²⁹ See 1955 Tax Policy Hearings, *supra* note 7, at 545-47, 551 (statement of Dr. Hall). Dr. Hall, a witness at the hearings, called for integration to put an end to close C corporation tax shelters and the conversion of low taxed retained earnings into capital gains or the date of death elimination of tax. See *id.* Other economists opposed integration because it would impose high outside rates on retained earnings or because a dividends paid deduction would tilt the playing field away from small close corporations. See *id.* at 554-556, 560, 562-564 (debate between Dr. Hall, Edwin Cohen, Committee Chairman Mills, and others). See also 1959 Panel Discussions, *supra* note 23, at 845-846, 854-55 (Dr. Shoup summarizing inside shelter use of C corporations in 1950 and suggesting full integration as to those who use C corporation as inside shelter), 860-61 (debate on incidence of corporate tax and premise of over- and under-taxation of shareholders), 863-64 (colloquy between Dr. Shoup and Representative Byrnes on parameters of inside shelter and difficulties in measuring extent of use, 866-69 (summation by Representative Alger of policy and impact questions raised by witnesses and ensuing debate); 1978 House Hearings, *supra* note 23, at (Part 6) 3516-33 (statement of Professor Gaffney advocating mandatory partnership passthrough of income, at least as to close C corporations, to eliminate inside shelter). The 1984 Treasury Proposals simultaneously advocated elimination of the graduated inside corporate brackets in favor of a flat 33% on net corporate income and the creation of a 50% dividends paid deduction to ameliorate double taxation. See 1984 Treasury Proposals, *supra* note 9, at 128-29, 136.

³⁰ Treasury explained the theory of economic efficiency or neutrality as follows:

One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. It would not discourage competition by granting special preferences only to one industry or one type of financial institution. In short, an ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy — an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want,

partnership form³¹ and vertical disparity as to wage earners in general,³² an example of the results of the failure to apply a deep structure analysis to the integration issue. Under the close C corporation graduated rates, the corporate-shareholder structure

how goods and services should be produced, and how business should be organized and financed.

Economic neutrality is furthered by a few simple rules of tax design. Perhaps most importantly, income from all sources should be taxed equally; otherwise, too many resources will be devoted to activities subject to the lowest taxes. For the same reason, tax liability should not depend on how income is spent. Uniform treatment of all sources and uses of income requires a comprehensive definition of income for tax purposes.

1984 Treasury Proposals, *supra* note 9, at 13.

The Joint Committee Staff succinctly explained the underlying economic theory:

The output of the economy depends not only in the size of the capital stock but also on its composition. In the absence of taxes, the operation of a competitive economy causes capital to flow to sectors where it is expected to earn the highest rate of return. This results in the allocation of investment that produces the largest amount of national income. However, if non-neutral taxes are imposed, potential output may be reduced because too much capital will tend to accumulate in lightly taxed sectors, and too little capital will be invested in highly taxed sectors. Thus, in evaluating the effects of tax reform on capital formation it is necessary to examine both the level and allocation of investment.

Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *Economic Issues Relating to the House-Passed Tax Reform Bill (H.R. 3838)*, 7 (Comm. Print 1986) [hereinafter *Economic Issues*] (footnote omitted). See generally, Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 *Fordham L. Rev.* 395, 410-28 (1987).

³¹ In the 1953 House Hearings accompanying the birth of the 1954 Code, F.N. Bard, an enterprising manufacturer and farmer from Illinois with an Arizona ranch, proposed a provision for relief of the business operating in the partnership form from the inequity of a higher tax rate than if operating in corporate form. See *Hearings on Forty Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Ways and Means Committee*, 83d Cong., 1st Sess. 1364-65, 1368 (1953) [hereinafter *1953 House Hearings*]. Bard proposed that unincorporated businesses be allowed to separate their venture capital income (income from direct operation of business) from income received from investment in stocks, bonds and other investments. *Id.* at 1364. A corporate rate would apply to the business venture income and the individual tax rates to investment or non-business venture capital income. *Id.*

³² Net business income is taxed at 15% in the case of small C corporations, see I.R.C. § 11(b)(1)(A) (tax on corporations is 15 percent of income up to \$50,000), whereas most wages are taxed at 15%, some at 28%, and in the rare case, 33%. See I.R.C. § 1. Therefore, rates on income from capital are less than the rates on income from personal services. See generally 1978 House Hearings, *supra* note 23, at 3510 (statement of Jerry Godell). This constitutes the mirror image of the populist origins of the twentieth century income tax. See *infra* note 325 and accompanying text. "From the standpoint of fairness, not the slightest justification can be offered." Chirelstein, *Back From the Dead: How President Reagan Saved the Income Tax*, 14 *Fla. St. U. L. Rev.* 207, 211 (1986) (contrasting lower effective rate on investment income due to tax preferences with income from personal services). See also Yorio, *supra* note 30, at 401 n.49; *infra* note 43.

yielded less revenue on earnings than direct taxation would have³³, leaving the double tax system vulnerable to a "briar patch" argument³⁴ used by defenders of the status quo. The real issue is not whether a "double" tax is collected, but whether Treasury will collect the equivalent of even a single tax.³⁵

President Carter's Treasury, as the defender of the fisc and hence the policy of vertical and horizontal equity,³⁶ strongly opposed the inside shelter of the close C corporation.³⁷ President Reagan's Treasury, however, abandoned this position *sub silentio* in the 1986 passthrough entity hearings, ostensibly to promote certainty and ease of administration by acquiescing in state law corporate form,³⁸ but surely due in fact to political pressures (the lesson garnered from the political experience of the 1984 Treasury proposal which called for repeal of the inside graduated corporate

³³ See Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Corporate Taxation 4-5* (Comm. Print 1985) [hereinafter *Corporate Tax Reform Proposals*].

³⁴ The author's colleague Charles Koch, discussing the myth of double taxation, see *supra* note 29, insightfully dubbed double taxation as a "Brer Rabbit and the Briarpatch" argument. Corporate shareholders, like rabbits in a briarpatch, never thought that the double tax "thorns" of the 1954 Code "briarpatch" would pierce them. Defenders of the status quo wanted the inside shelter of corporate and shareholder level taxation even while they argue that a real double tax exists, and Committee members knowingly gave it to them. Here Doernberg & McChesney's "tax contracts" analysis appears apt. Doernberg and McChesney adopt the idea that tax legislation is a contract. "Status as a legislator confers on a senator or representative the legal authority to help or hurt private interests through taxation. In exchange for being helped or hurt, private interests will compensate legislators" with contributions to political campaigns, and even money for personal use. Doernberg & McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 Minn. L. Rev. 913, 914 (1987).

³⁵ That this is the real issue was suggested by Professor Graetz at an American Association of Law Schools Tax Workshop Luncheon in 1985.

³⁶ The authors of *Showdown at Gucci Gulch* paint the Treasury tax office prior to Assistant Secretary for Tax Policy Roger Mentz' tenure from 1986 to 1987 as by-and-large standing "somewhat above politics, promoting 'good' tax policy and opposing 'bad' tax policy." Birnbaum & Murray, *supra* note 23, at 262. Be that as it may, Mentz himself prides himself on following politics and not tax ideals. See Sheppard & Rosen, *An Interview With Assistant Secretary J. Roger Mentz*, 36 Tax Notes 465, 469 (Aug. 13, 1987).

³⁷ See 1978 Senate Hearings, *supra* note 7, at 136 (statement of Secretary of Treasury Blumenthal).

³⁸ Assistant Secretary Mentz admitted that few close C corporations possessed any of the traditional corporate resemblance factors. See 1986 Passthrough Entity Hearings, *supra* note 8, at 19; *infra* note 120. However, he asserted that state law form, i.e., "objective" rules, was preferable to functional subjective classification, with the limited exception of publicly traded partnerships. See *id.* at 27-28.

brackets³⁹) rather than sober-minded policy considerations.

Corporate management's intransigence against full integration (due to fear of shareholder demands for distributions of earnings) has limited the integration debate over the past decade to dividend deduction or credit proposals.⁴⁰ Such split-rate, partial integration proposals would have increased the vertical and horizontal inequities of the 1954 and 1986 Code treatment of corporations and shareholders.⁴¹ Not surprisingly, therefore, administration and congressional attempts over the last decade, as in the fashioning of the 1986 Code, to enact such partial integration proved unsuccessful as well.⁴² Consequently, the corporate two-tier tax system continues, violating horizontal and vertical equity, although less so after the 1986 Act's substantial increase of the corporate tax.⁴³

³⁹ 1984 Treasury Proposals, *supra* note 9, at 128-29. Early in the formulation of the President's proposals, Treasury Secretary Baker met with the president of the National Federation of Independent Business, "who was disturbed by the elimination of lower tax rates for small businesses." Birnbaum & Murray, *supra* note 23, at 80.

⁴⁰ See 1978 House Hearings, *supra* note 23, at 94, 102, 487 (statement of Secretary of the Treasury Blumenthal), 6148-50 (statement of Professor Graetz). Minarik describes the opposition to Carter's partial integration proposal as splitting the investment and business communities. The split was widened by the proposed repeal of capital gains and helped to doom the Carter Tax Proposals. See Minarik, *supra* note 23, at 1363; 131 Cong. Rec. H12,243 (daily ed. Dec. 17, 1987) (statement of Speaker O'Neill).

⁴¹ See 1978 House Hearings, *supra* note 23, at 3504, 6107 (statement of former Commissioner Sheldon Cohen).

⁴² See Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 894 (June 1, 1987); 1986 Passthrough Entity Hearings, *supra* note 8, at 25-26 (statement of Mentz). Then Assistant Secretary for Tax Policy Ronald Pearlman has stated, however, that in 1985 corporations were not opposed to dividend relief despite conventional wisdom; instead, opposition arose from revenue implications. See President's Proposals, *supra* note 8, at 126; Acquisitions and Mergers Hearings, *supra* note 27, at 222 (1985) (statement of Assistant Secretary of Treasury Ronald Pearlman).

⁴³ One type of disparity is the horizontal and vertical disparity created by the lower rates that exist in a close C corporation compared to the shareholder's higher marginal bracket. See *supra* note 32 and accompanying text. The disparity as to large C corporations is more complex. Historically, the maximum large C corporation bracket has been considerably lower than the maximum outside individual bracket (e.g., 52% corporate versus 91% individual in 1954 and 48% corporate versus 70% individual as to other than "earned income" in 1980 prior to ERTA), but ERTA narrowed the rate gap to 46% corporate vs. 50% individual. The 1986 Code actually increased the maximum corporate rate (34%) above the nominal maximum individual rate (28%), but not by much for most high income taxpayers, i.e., 34% vs. phantom 33%. However, this may not be the correct comparison. The large C corporate effective rate (21% of economic income prior to the Tax Reform Act of 1986 and 26% after the Act, see *infra* note 195 and accompanying text) is lower than the maximum individual marginal rate (28% or 33%) but not lower than the 19% to 22% of economic income effective rate for high income ("high income" includes two groupings of income

D. The Tax Legislative Process

The dominant pattern of tax reform under the 1954 Code was elimination of inflation-driven bracket creep through tax cuts and tax expenditures,⁴⁴ with specific treatment of usually extreme tax abuses⁴⁵ which nevertheless left basic tax expenditures in place.⁴⁶ With the prospective (1985) wholesale elimination of bracket creep by the Economic Recovery Tax Act of 1981 ("ERTA") looming ahead,⁴⁷ the congressional budget and tax committees became the facilitators if not the driving force behind the substantial revenue increases enacted in 1982 and 1984,⁴⁸ during which time the ERTA rate cuts and indexing remained in effect. The 1986 Act provided an individual tax cut offset by an equivalent corporate sector tax increase⁴⁹ (probably adding needed progressivity to the Code⁵⁰),

levels, \$100,000 to \$200,000 and over \$200,000) individual taxpayers before and after the Act. See Congressional Reports, Documents at a Glance: JCT Tables of Distributional Data by Income Class in Tax Reform Bill, 33 Tax Notes 73, 74 (Oct. 6, 1986) (a summary of the Tax Reform Act of 1986). For 1988 the average income tax rate for individual taxpayers with income between \$100,000 and \$200,000 was estimated to be 18.9%; for taxpayers whose income exceeds \$200,000, 22.3%. See *id.* Thus, prior to the 1986 Act, high income individuals and corporations carried a heavier effective rate on economic income. See *infra* note 195 and accompanying text.

⁴⁴ The origins of the "tax expenditure" concept and Professor Surrey's role in its development as Assistant Treasury Secretary for Tax Policy are traced in Forman, *Origins of the Tax Expenditure Budget*, 30 Tax Notes 537 (Feb. 10, 1986).

⁴⁵ See, e.g., the minimum tax and private foundation provisions of the Tax Reform Act of 1969, Tax Reform Act of 1969 §§ 301, 101 (1969), and the at risk and capitalization of tax shelter expenditure provisions of the Tax Reform Act of 1976. Tax Reform Act of 1976 §§ 201-214 (1976).

⁴⁶ Until the 1986 Code, individual tax shelter use continued to grow despite anti-shelter provisions of the Tax Reform Act of 1976 and of the tax revisions of 1982 and 1984. See Hearing on High-Income Taxpayers and Related Partnership Tax Issues before the Subcomm. on Oversight of the House Ways & Means Comm., 99th Cong., 1st Sess. 8, 12-13, 18-24, 43-44, 98 (1985) [hereinafter *High-Income Taxpayer Hearings*] (statement of Assistant Secretary of Treasury Ronald Pearlman).

⁴⁷ See ERTA § 104, Pub. L. 97-34, 95 Stat. 172. See generally, Staff of Joint Comm. on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Tax Act of 1981* 38-40 (Comm. Print 1981).

⁴⁸ See Handler, *Budget Reconciliation and the Tax Law: Legislative History or Legislative Hysteria?*, 37 Tax Notes 1259, 1262-1263 (Dec. 21, 1987) (contrasting reconciliation driven legislation with collegial tax reform efforts, e.g., the Installment Sales Revision and Bankruptcy Tax Acts of 1980 and Subchapter S Revision Act of 1982); Leonard, *Perspectives on the Tax Legislative Process*, 38 Tax Notes 969, 972-74 (Feb. 29, 1988).

⁴⁹ See Sunley, *supra* note 23, at 63. Questions have been raised as to whether the corporate sector increase will really be equivalent. See, e.g., *The Tax Reform Act of 1986: Implications for the Future*, Hearings Before the Joint Econ. Comm., 99th Cong., 2d Sess. 68, 72-

and by indirect means substantially broadened the individual income tax base (through changes often concentrated on high income taxpayers)⁵¹ and the corporate minimum tax base.⁵² OBRA, as its name indicates, was also driven by the budget reconciliation process and provided further base broadening with a number of rela-

73 [hereinafter Future Implications of 1986 Act Hearings] (statement of Alan Greenspan) (corporate revenue assumptions based on continued high durable equipment outlays by producers); Kiefer, *The Progressivity Effects of the Individual Income Tax Revisions in the Tax Reform Act of 1986*, 33 Tax Notes 1189, 1192 (Sep. 22, 1986) (timing or accounting changes which account for substantial part of corporate sector increase not equivalent to individual side permanent reductions). The preliminary data from fiscal year 1987 confirms this doubt as to the magnitude of the corporate sector increase. See *infra* note 234.

⁵⁰ See Future Implications of the 1986 Act Hearings, *supra* note 49, at 15 (statement of Robert McIntyre); Kiefer, *supra* note 49, at 1192; Ott, *The Impact of the 1986 Tax Reform Act on Progressivity*, 33 Tax Notes 1223, 1226 (Dec. 29, 1986); Sunley, *supra* note 23, at 63 ("while corporate tax incidence is always controversial, if one assumes that the increase in corporate taxes is borne by stockholders or owners of capital generally, the 1986 Act increases the overall progressivity of the Federal income taxes"). The model on incidence Sunley apparently uses is set forth in more detail in Ballentine, *The Short-Run Distribution Effect of Tax Reform*, 31 Tax Notes 1035, 1038-39 (June 9, 1986).

⁵¹ The major individual side base broadenings were (1) the repeal of deduction for state and local taxes (\$968 million in 1987, \$5,197 million in 1988, \$4,708 million in 1989, \$4,907 million in 1990, and \$5,131 million in 1991, see Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 46 (Comm. Print 1986) [hereinafter 1986 Bluebook]); (2) raising the floor on deductibility of medical expenses (\$186 million in 1987, \$1,223 million in 1988, \$1,141 million in 1989, \$1,276 million in 1990, and \$1,427 million in 1991, see *id.* at 52); (3) imposing a floor on employee business expenses (\$694 million in 1987, \$4,630 million in 1988, \$4,716 million in 1989, \$5,039 million in 1990, and \$5,383 million in 1991, see *id.* at 81); (4) elimination of the capital gains preferences (not broken out from basic rate structure changes, see *id.* at 180); (5) passive activity gain and loss changes (\$753 million in 1987, \$3,008 million in 1988, \$4,831 million in 1989, \$6,811 million in 1990, and \$8,003 million in 1991, see *id.* at 251); (6) a new limitation on the deduction of consumer interest (\$620 million in 1987, \$4,511 million in 1988, \$6,260 million in 1989, \$8,370 million in 1990, and \$9,597 million in 1991, see *id.* at 270); and (7) a strengthened minimum tax (\$848 million in 1987, \$3,904 million in 1988, \$2,251 million in 1989, \$862 million in 1990, and \$334 million in 1991, see *id.* at 473). The effects of the last four items are concentrated in the upper income levels. See Kies, *The Current Political, Budgetary, and Tax Policy Environment Suggests the Possibility of Major Federal Tax Legislation in the 100th Congress*, 35 Tax Notes 179, 184 (April 13, 1987) [hereinafter Kies].

⁵² See Sunley, *supra* note 23, at 65. The corporate minimum tax changes (\$3,087 million in 1987, \$5,387 million in 1988, \$5,072 million in 1989, \$4,466 million in 1990, and \$4,155 million in 1991, see 1986 Bluebook, *supra* note 51, at 473) pale in comparison to the capitalization and long-term contract tax accounting changes (\$7,243 million in 1987, \$10,971 million in 1988, \$10,463 million in 1989, \$9,225 million in 1990, and \$7,384 million in 1991, see *id.* at 524, 530) and the repeal of ITC (which also impacts on individual taxpayers) (\$18,879 million in 1987, \$21,413 million in 1988, \$30,501 million in 1989, \$37,692 million in 1990 and \$46,802 million in 1991 see *id.* at 126).

tively small revenue raising items,⁵³ largely drawn from prior Joint Committee and Treasury studies.⁵⁴ OBRA maintained the 1986 Act rate cuts and structural changes as to capital gains and PALs. Despite the base broadening, Ways and Means Committee Chairman Rostenkowski has said that he expects a major revenue increase will be needed in 1989 and recently stated that he would "strongly resist" changes to the 1986 Code,⁵⁵ presumably meaning, e.g., a return to the capital gains preference and higher rates of pre-1986 law. Such a statement may also signal that further base broadening, following the pattern of 1982, 1984 and 1987, may occur.

II. OBRA CHANGES TO TAXATION OF PTPs AND PSCs

A. Classification of PTPs

1. Treatment as a Corporation

New section 7704(a) treats a PTP as a corporation for federal income tax purposes.⁵⁶ On the first day of such treatment, a PTP

⁵³ See Teuber, Ways and Means Democrats Approve \$6.3 Billion in Revenue Raisers, Will Complete Action This Week, 37 Tax Notes 119, 121 (Oct. 12, 1987) [hereinafter Teuber, Ways and Means]; Teuber, GOP Maneuvering Cuts Ways and Means Markup Short, 37 Tax Notes 6-8 (Oct. 5, 1987). The author counts thirty-two income and estate and gift revenue increase provisions, including extension of effective date provisions.

⁵⁴ Senator Bentsen, Chairman of the Senate Finance Committee, was outwardly more receptive to looking at "leftovers" from the 1984 Treasury Proposals, *supra* note 9, and the 1985 President's Proposals, *supra* note 9, than were the House Democrats. See Teuber, Finance to Look at Treasury I and Treasury II for Revenue, 37 Tax Notes 9 (Oct. 5, 1987) (Sen. Bentsen states he will look to Treasury proposals for raising revenue); Teuber, Ways and Means, *supra* note 53, at 120 (Rep. Rostenkowski reports House Democrats reject the Treasury Proposals).

⁵⁵ Teuber & Rosenthal, Rostenkowski and Chapoton Speak on Tax Simplification, 38 Tax Notes 1288, 1289 (Mar. 21, 1988). Apparently the power of the idea of low rates and economic efficiency has now seized Chairman Rostenkowski. Earlier he saw base broadening as a prelude to rate hikes. See N.Y. Times, Aug. 18, 1986, at B-11, col. 1 (Rostenkowski proposal to raise rates). For an excellent populist manifesto along these lines, see Future Implications of the 1986 Act Hearings, *supra* note 49, at 18. The idea of low rates and economic efficiency has gained support among others as well. See, e.g., Tax Reform Symposium Proceedings, 31 Vill. L. Rev. 1787, 1792 (1986) (statement of David Brockway, Chief of Joint Comm. on Taxation Staff).

⁵⁶ I.R.C. § 7704(a) (1987). The effective date contains a ten year grandfather provision for PTPs existing on December 17, 1987. See OBRA § 10211(c)(1)(B). Then Assistant Secretary Mentz predicted this grandfather clause and so argued for immediate PTP action, as it was better a grandfather now than later. See 1987 Senate MLP Hearings, *supra* note 7, at 51 (statement of Mentz); 1987 House MLP Hearings, *supra* note 16, at 11, 35-36, 40 (statement

is deemed to transfer all of its partnership assets (subject to any partnership liabilities) to a newly formed corporation in exchange for its stock, which the PTP then distributes to its partners in liquidation.⁵⁷

"Publicly traded" means that the partnership's interests are traded on an established securities market or readily traded on a secondary market or substantial equivalent.⁵⁸ An "established securities market" includes an over-the-counter market as well as a national securities exchange.⁵⁹ The secondary market test encompasses partnership interests where the owners are "readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market."⁶⁰ The litmus test is the presence of a willing market maker, but occasional accommodation transfers or buy-sell transactions do not usually constitute a secondary market or its equivalent.⁶¹ Congress deliberately left the interstices gray so as to discourage aggressive taxpayer arguments which have traditionally sought to take advantage of provisions which were once more

of Mentz).

⁵⁷ See I.R.C. § 7704(f) (1987). This rule contravenes the general partnership incorporation rule where, most recently, form has controlled. See Rev. Rul. 84-11, 1984-2 C.B. 88 (revoking Rev. Rul. 70-239, 1970-1 C.B. 74. The revoked ruling had adopted the rule later enacted by OBRA.). See generally Barrie & Jones, *Incorporating an Ongoing Partnership: Selecting the Appropriate Method*, 3 J. Part. Tax'n 335 (1987) (examination of the consequences of incorporating a partnership; results depend on form of transaction). Tax reform seems to be a time for settling old scores of administrators, as OBRA well illustrates in this provision as well as in other OBRA provisions. For example, § 10222, I.R.C. § 1503(e), overruled *Woods Investment Co.*, 85 T.C. 274 (1985). And § 10402 of OBRA, I.R.C. § 2036(c), overturned prior service defeats in the area of estate tax regarding estate freezes. See *Estate of Boykin v. Commissioner*, 53 T.C.M. (CCH) 345 (1987). See generally Abbin, *Taking the Temperature of Asset Value Freeze Approaches: What's Hot, What's Not*, 66 Taxes 3 (1988).

⁵⁸ See I.R.C. § 7704(b).

⁵⁹ See 1987 House Report, *supra* note 21, at 1070; H.R. Rep. No. 495, 100th Cong., 1st Sess. 947 (1987) [hereinafter 1987 Conference Report].

⁶⁰ 1987 Conference Report, *supra* note 59, at 948. Then Assistant Secretary of Treasury Mentz had suggested that it would be necessary to go beyond registration on a stock exchange to include situations "where there is a market made by one or more investment bankers so that you have, in effect, the same degree of shareholder liquidity as in a publicly held corporation." 1987 Senate MLP Hearings, *supra* note 7, at 52. The Conference report went beyond the question of whether a market had been made, and focused on the market characteristics of certainty and liquidity and whether they were present. See Sheppard, *The Poker Game: Defining "Publicly Traded Partnership"*, 39 Tax Notes 22 (April 4, 1988).

⁶¹ 1987 Conference Report, *supra* note 59, at 948. Exercises of put or call rights, however, may give rise to such "ready tradeability." See *id.*

"bright line."⁶²

2. *Passive Business Passthrough Exception*

If 90% or more of a PTP's gross income consists of qualifying "passive-type income," statutory corporate classification does not attach under section 7704(a) and (c).⁶³ The "passive-type" income concept is familiar in the contexts of corporations receiving special treatment (e.g., personal holding companies or "PHCs"⁶⁴ and pass-through separate entity S corporations⁶⁵) as well as conduit separate entities (including RICs⁶⁶ and REITs⁶⁷). Section 7704(d) uses

⁶² Sheppard, *supra* note 60, at 22-24. For an discussion of publicly "offered" limited partnerships, "trading desks," and NAPEX (National Partnership Exchange) and public trading, see *id.* Sheppard correctly points out that § 7704(b)'s standard of readily traded on the substantial equivalent of a secondary market was intended as a "back stop," not as a widening of the reclassification net to catch large publicly offered and traded limited partnerships. See *id.* at 22. But she raises the interesting question whether in fact some common public offering practices, such as trading desks, listing on NAPEX or certain redemptions and resales, may functionally constitute public trading. If so, this question might be more appropriately addressed by Congress and not the drafters of regulations.

⁶³ I.R.C. § 7704(c)(2), (a).

⁶⁴ See I.R.C. § 543.

⁶⁵ See I.R.C. § 1362(d)(3)(D).

⁶⁶ See I.R.C. § 851(b)(2). A "regulated investment company" ("RIC") or mutual fund is a domestic corporation meeting the Investment Company Act of 1940 registration requirements in that it derives at least 90% of its ordinary income from passive investment income, has a diversified portfolio, and distributes at least 90% of its net income to shareholders. 1986 Bluebook, *supra* note 51, at 375.

A RIC generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Thus, a RIC is treated, in essence, as a conduit for Federal income tax purposes. A RIC does not receive a deduction with respect to dividends paid unless the distribution is pro rata with respect to other shares of the same class (sec. 562(c)).

Id.

A limited passthrough of entity-level long-term capital gain is provided. See *id.* No ordinary or capital loss passthrough is available; therefore, loss as to mutual fund shares is recognized under the general rules applicable to shares of stock. See *infra* notes 219-20 and accompanying text.

⁶⁷ See I.R.C. § 856(c)(2).

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property. . . .

In order to qualify as a REIT and thereby receive conduit treatment, an entity

a rationalized PHC-type model in defining passive-type income as interest, dividends and the true targets,⁶⁸ real property rents and income from mineral or natural resource development, and gains from assets used in such activities.⁶⁹ However, PTP passive-type income is not coextensive with PHC or any other passive income scheme, e.g., the Code's PAL or Subchapter S provisions.⁷⁰

Congress in effect made the REIT rules non-exclusive, with certain REIT-type income qualifying for passthrough PTP treatment.⁷¹ A Treasury representative and a witness for the apartment rental industry who testified at the master limited partnership hearings demonstrated that the existing REIT provisions were more restrictive than the PTP format as to control, management, distribution requirements and reinvestment of certain gains.⁷² But

must satisfy four tests on a year-by-year basis; organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

1986 Senate Report, *supra* note 8, at 769. REITs also may passthrough long-term capital gain through a "capital gain dividend." See *id.* at 770.

⁶⁸ See 1987 Senate MLP Hearings, *supra* note 7, at 73-74 (statement of Mentz); 1986 Passthrough Entity Hearings, *supra* note 8, at 31 (statement of Mentz); 1987 House Report, *supra* note 21, at 1068. Assistant Secretary Mentz' explanation for the Administration's review of the PTP issue in 1987 after having supported the Treasury position in 1986 was its concern about "the effects that changes in classification of MLPs would have on activities traditionally conducted in partnership form." 1987 Senate MLP Hearings, *supra* note 7, at 48, 55 (statement of Mentz). See also Sheppard, No More, No More: Finance Subcommittee Ponders Entity Classification, 36 Tax Notes 360, 361 (July 27, 1987).

⁶⁹ See I.R.C. § 7704(d)(1)(C), (E), (F). The odd inclusion for fertilizer as a "natural resource" probably arose from a recent acquisition PTP in that field. See 1987 Senate MLP Hearings, *supra* note 7, at 89.

⁷⁰ See generally 1987 House Report, *supra* note 21, at 1069.

⁷¹ See I.R.C. § 7704(c)(2), (d)(3).

⁷² See 1987 House MLP Hearings, *supra* note 16, at 353-55 (statement of Lewis Sandler of the National Apartment Association) (listing substantive differences between REITs and real estate PTPs focusing on management and distribution requirements and reinvestment restrictions), 73 (statement of Herbert Lerner of the American Institute of Certified Public Accountants), 316, 320 (statement of Myles Tanenbaum of EQK Partners). See also Passthrough Entity Hearing Pamphlet, *supra* note 8, at 11; and 1987 Senate MLP Hearings, *supra* note 7, at 47 (statement of Mentz). The Tax Reform Act of 1986 liberalized many existing REIT rules, see 1986 Bluebook, *supra* note 51, at 390, while tightening other REIT and other conduit entity rules, especially deferral of mutual fund income. See *id.* at 376-82.

new section 7704(c)(3) denied the continued passive business pass-through exception to nearly every PTP which could qualify as a RIC or mutual fund (except for a PTP selling, for example, commodities or commodities futures)⁷³ so as not "to alter the requirements for conduit tax treatment . . . applicable to regulated investment companies";⁷⁴ and the legislative history extends this proscription to REMICs.⁷⁵ However, any policy distinction between REITs and RICs or REMICs appears tenuous.

Rules similar to those of REITs apply to incidental rentals of personal property in connection with a rental of real property.⁷⁶ Rent contingent on income or profits of a non-real estate activity usually does not qualify for passthrough treatment, due to the greater degree of downside risk and upside potential for economic gain.⁷⁷ This is an important new distinction, focusing not on the activities of the enterprise, the traditional criterion for passive or active business status,⁷⁸ but on a risk or economic analysis of the return on investment.

The legislative history carefully points out that meeting the passive income tests does not imply that entities generating such income are presumed to be partnerships.⁷⁹ While this seemingly opens the door for regulatory or judicial reclassification of such

Nevertheless, REITs were not popular to real estate operators due to inflexibility and market perception. See 1987 Senate MLP Hearings, *supra* note 7, at 134 (statements of Cohen and Sandler). See generally *id.* at 198-99 (statements of Cohen and Chapoton); Sheppard, *Sleeping Dogs: Publicly Traded Limited Partnerships Come of Age*, 34 *Tax Notes* 1254, 1255 (Mar. 30, 1987).

⁷³ The new provision does not apply to PTPs selling commodities or commodities futures. See I.R.C. § 7704(c)(3).

⁷⁴ 1987 House Report, *supra* note 21, at 1068.

⁷⁵ See *id.* at 1068.

⁷⁶ See I.R.C. § 7704(d)(3).

⁷⁷ See 1987 House Report, *supra* note 21, at 1068-69.

[A]mounts based on gross income earned in connection with a non-real estate related activity such as a fast food operation are not treated as passive-type income. Interest or rent (or other amounts) contingent on profits involves a greater degree of risk, and also a greater potential for economic gain, than fixed (or even a market-indexed) rate of interest or rent, and thus is more properly regarded as from an underlying active business activity. Passive-type rental income also does not include income from rental or leasing of personal property.

Id.

⁷⁸ See Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics*, 6 *Va. Tax Rev.* 1, 109-11 (1986).

⁷⁹ See 1987 House Report, *supra* note 20, at 1068.

passthrough PTPs as corporations, reflections on policy and study of the past indicate that both Treasury and the courts should and will be reluctant to effectuate what Congress has failed to do.⁸⁰

Congress provided relatively generous rules for inadvertent failure to meet the 90% passive-type income floor. If the IRS determines the failure was inadvertent, the partnership takes steps within a reasonable time (one year, except to the extent the regulations provide otherwise⁸¹), and the partnership and each unit holder during the failure period agree to make "adjustments,"⁸² the partnership will be treated as meeting the 90% floor during the failure period.⁸³

B. PTPs and PAL Provisions

1. Active Business PTPs

The legislative history explains that income from PTPs classified as corporations generally is treated as dividend or "portfolio income,"⁸⁴ which passive activity losses may not offset.⁸⁵ According to a recent House report, "regardless of whether such income is characterized as income or gain (e.g., depending on whether it represents a distribution of earnings and profits under section 301),

⁸⁰ See, e.g., *Achiro v. Commissioner*, 77 T.C. 881, 884-95 and n.17 (1981) (court notes that Congress is aware of disparate treatment of self-employed individuals and corporate shareholder-employees and has not chosen to change the situation through legislation); 1987 Senate MLP Hearings, *supra* note 7, at 46 (statement of Mentz).

⁸¹ See *infra* note 83 and accompanying text.

⁸² The nature of the adjustments is not described in new section 7704(e), only that the adjustments will be made "as required by the Secretary." I.R.C. § 7704(e).

⁸³ See *id.* See also 1987 Conference Report, *supra* note 59, at 944.

⁸⁴ According to one commentator,

Portfolio income includes, as a general rule, the following types of income derived directly or indirectly through a pass-through entity:

(1) Income from interest, dividends, annuities and royalties not derived in the ordinary course of a trade or business.

(2) Gain attributable to the disposition of property producing income of a type described in (1), above.

(3) Gain attributable to the disposition of property held for investment (other than an interest in a passive activity).

Mertens Law of Federal Income Tax § 24C.09 (1986) (footnotes omitted). See I.R.C. § 469(e)(1)(A)(i)(I), (ii)(I), (ii)(II).

⁸⁵ Under the PAL rules, losses from a passive activity generally cannot offset positive income sources such as portfolio income or salary prior to a taxable disposition. See 1986 Bluebook, *supra* note 51, at 212-13, 215. See generally Rock & Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 Va. Tax Rev. 1 (1987).

income from such entities is properly treated as portfolio income for purposes of the passive loss rule.”⁸⁶ Presumably such owner-level realization of portfolio income is triggered by actual distributions and not by the mere presence of a “distributive share” without distribution, which is the partnership rule.⁸⁷ Entity-level losses from such a corporate PTP are not passed through to shareholders but instead are carried back and forward under the NOL rules.⁸⁸

2. Complete Separate Basket Treatment for Passthrough PTPs

New section 469(k)(1) mandates complete “separate basket” application of the passive loss rules to each passthrough publicly traded partnership.⁸⁹ In essence, this PAL passthrough PTP rule results in losses from a passthrough PTP being offsettable against income from that PTP only. Moreover, passive losses inside a passthrough PTP cannot offset its own inside portfolio income.⁹⁰ (This theme runs throughout the PAL provisions.⁹¹) Finally, positive income from a passthrough PTP is treated as portfolio income.⁹²

The intended overall result is that net losses and credits of a partner from each publicly traded partnership be suspended at the partner level, carried forward (not back) and netted against income, other than the partnership’s portfolio income, from (or tax liability attributable to) that publicly traded partnership, and that suspended losses are allowed upon a complete disposition of the partner’s interest in the partnership. [And a partner’s distributive share of a passthrough PTP’s income cannot soak up, i.e., be offset by, passive activity losses].⁹³

The drafters of the House PAL-PTP provision reasoned that while a non-passthrough PTP would be treated as a corporation for all purposes, including the PAL rules, with any distributions treated as portfolio income and its losses not passing through,⁹⁴

⁸⁶ 1987 House Report, *supra* note 21, at 1071.

⁸⁷ See I.R.C. § 702 (rules for accounting for partnership income).

⁸⁸ See I.R.C. § 172 (net operating losses).

⁸⁹ See I.R.C. § 469(k)(1). See generally Lipton, Section 469 and PTP’s: Impact of the Omnibus Budget Reconciliation Act of 1987, 38 Tax Notes 183 (Jan. 11, 1988).

⁹⁰ See 1987 House Report, *supra* note 21, at 1074.

⁹¹ See 1986 Senate Report, *supra* note 8, at 728-30.

⁹² See 1987 House Report, *supra* note 21, at 1071, 1073.

⁹³ 1987 House Report, *supra* note 21, at 1074.

⁹⁴ See *id.* at 1071.

PTPs not treated as corporations or passthrough PTPs could maintain (absent regulatory recharacterization of their income as "portfolio income" (i.e., as not passive activity gain) under original section 469(k)) that their income constituted "passive income," thus soaking up PALs.⁹⁵ The House separate basket PAL rule was designed to forestall both use of income from a passthrough PTP to soak up PAL losses and generation of PAL losses by a passthrough PTP. Treatment of other PTPs as corporations and their income as portfolio income achieves roughly the same result. The same result will occur at the owner level as to income from passthrough and separate entity PTPs only if the owners' distributive share of taxable income from a passthrough PTP and actual (cash flow) distributions from a corporate PTP can be made to coincide. The inside loss regimes for active and passive activity PTPs, however, may vary substantially, creating horizontal disparities, at least as to non-portfolio income activities.

Whether the passthrough-PAL-suspension-of-losses model or the model incorporating limited NOL carryback and carryover, with no direct offset against disposition of gain, applies to corporate PTPs is hard to judge, based on the statutory language and legislative history. The 1987 conference report flatly states that it follows the Senate amendment of the House bill (with modifications not here relevant),⁹⁶ but the Senate amendment did not treat any PTPs as corporations.⁹⁷ Hence, the conference PAL-PTP rule ended up encompassing all PTPs, not just passthrough (i.e., passive-type income) PTPs. Finally, new section 469(k)(1) speaks only of publicly traded partnerships, without further limitation as to passthrough PTPs. (The House provision was similarly worded.) If the PAL-PTP rule encompassed all PTPs, the PAL-PTP inside portfolio income passive loss separate basket rule literally—but not logically—would apply under section 469(k) inside to a corporate

⁹⁵ See *id.* at 1072. While testimony at the 1987 House MLP Hearings implied this stance, see 1987 House MLP Hearings, *supra* note 16, at 366 (statement of Jeffrey Rosenthal on behalf of the National Association of Realtors and Real Estate Securities and Syndication Institution), the legislative history to the 1986 Code suggests otherwise. See 1986 Senate Report, *supra* note 8, at 730 (example of roll-out MLP distributed by C corporation); 1986 Bluebook, *supra* note 51, at 234; 1986 Passthrough Entity Hearings, *supra* note 8, at 12-13 (statement of Mentz).

⁹⁶ See 1987 Conference Report, *supra* note 59, at 952.

⁹⁷ See S. Rep. No. 63, 100th Cong., 1st Sess. 186 (1987) [hereinafter 1987 Senate Report].

PTP. But this reading would produce conflicts between the envisioned individualized suspension of PAL-PTP losses⁹⁸ and corporate-NOL rules.⁹⁹ Obviously a technical correction is in order.

The final OBRA provision¹⁰⁰ excepted from the passthrough PTP separate PAL basket the \$25,000 (deduction equivalent) per natural partner offset under the then-existing PAL rules for rental real estate losses (with a waiver for low-income housing of an otherwise applicable "active participation" requirement).¹⁰¹ According to the 1987 conference report, "a partner in a publicly traded partnership may utilize his share of partnership low income housing credits and rehabilitation credits against tax liability attributable to non-partnership income to the extent of his unused \$25,000 (deduction equivalent) allowance."¹⁰²

3. *Definitional Conflict*

The new PAL passthrough PTP provision contains a more fundamental technical flaw which is possibly fatal. Section 469(c) provides the definition of the centerpiece of the PAL regime: "passive activity," which it defines as "any activity . . . (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."¹⁰³ PAL was thus aimed at active business/passive owner combinations. In contrast, pass-through PTP provisions were targeted at passive activity/passive owner combinations. The 1986 Senate legislative history focuses almost exclusively on "material participation" or passivity of ownership, with no amplification of the first part of the definition: "conduct of a trade or business." Historically a passive operation, such as net leasing of real estate or mere collection of income, did not

⁹⁸ See *supra* note 93.

⁹⁹ See I.R.C. § 172(b).

¹⁰⁰ See I.R.C. § 469(i)(1), (6)(B) and (k)(1) (last sentence).

¹⁰¹ See I.R.C. § 469(i)(1), (2), and (6)(B).

¹⁰² 1987 Conference Report, *supra* note 59, at 952. This carve-out for low income housing and rehabilitation credits was strongly supported by Ways and Means Subcommittee Chairman Rangel. See Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms before the House Comm. on Ways and Means, 98th Cong., 2d Sess. 28 (1984) [hereinafter Tax Shelter Hearings] (exchange between Rep. Rangel and Assistant Secretary for Tax Policy John Chapoton); Matthews, Treasury Opposes Expansion of Low-Income Housing Credit, 38 Tax Notes 1014 (Mar. 7, 1988).

¹⁰³ See I.R.C. § 469(c).

attain trade or business status, but mere investment status.¹⁰⁴ The 1986 Code provides an ad hoc regulatory remedy, which encompasses most rental real estate, for this conceptual defect.¹⁰⁵ Section 469(c)(6) authorizes regulations which are to include in the term "trade or business" any activity in connection with the section 212 production of income. But the legislative history indicates that a narrow reading of section 469(c)(6) is in order, such that activities generating more than portfolio income but not rising to trade or business status are considered passive activities.¹⁰⁶ The result is that while Congress intended that section 469 apply separately to items attributable to a passthrough PTP, the section read literally would not apply at all to losses from a passthrough PTP if 90% of its gross income is derived from interest or dividends, i.e., portfolio income, since the generation of such income does not constitute a "passive activity."¹⁰⁷ Thus losses from an interest or dividend earning passthrough PTP appear not to be subject to any PAL rules. Note that real estate and natural resource income passthrough PTPs would appear to be ideal candidates for treatment as section 212 activities in connection with a trade or business. On the other hand, income from an interest-dividend income PTP would constitute portfolio income not offsettable by losses from a passive activity. Again, a technical correction is in order, preferably by statute rather than regulation.

C. Personal Service Corporations

The new PSC inside tax rate rule is starkly simple: PSCs are not eligible for section 11(b)(1) graduated inside corporate rates and instead are subject to a flat rate of 34%.¹⁰⁸ Congress failed to provide any special one-time disincorporation relief, as it did in 1982

¹⁰⁴ See *supra* note 78; *infra* note 107.

¹⁰⁵ In drafting section 469 in the Tax Reform Act of 1986, Congress included any rental activity in the term passive activity regardless of whether the owner materially participated. See 1986 Senate Report, *supra* note 7, at 720.

¹⁰⁶ See H.R. Rep. No. 841, 99th Cong., 2d Sess. II-138 (1986) [hereinafter 1986 Conference Report].

¹⁰⁷ While certainly passive at the owner level, generating such portfolio income cannot satisfy the "activity portion;" it constitutes neither a trade or business nor a covered section 212 activity greater than mere collection of portfolio income. See Lee, *supra* note 78, at 109-11.

¹⁰⁸ See I.R.C. § 11(b)(2).

in connection with the enactment of legislative parity in retirement plans.¹⁰⁹ The apparent expectation is that most, if not all, PSCs will elect S corporation status.¹¹⁰

III. DEEP STRUCTURE CLASSIFICATION, INTEGRATION AND PASSIVE LOSS POLICY

A. Classification

Historically, both the courts and Treasury regulations classified entities as separate, i.e., as "associations" taxable as corporations,¹¹¹ on the basis of the *Morrissey*¹¹² "corporate resemblance" factors: (1) continuity of the entity's life,¹¹³ (2) centralized manage-

¹⁰⁹ See Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248 § 247, 95 Stat. 172.

¹¹⁰ Conversation of author with Robert Leonard, Majority Chief Counsel to House Ways and Means Committee at College of William & Mary Annual Tax Conference on December 5, 1987. Such a pro-S corporation slant may fit a Staff hidden agenda; former Assistant Secretary of Treasury Mentz and Chief of Joint Committee Staff Pearlman are on record as favoring an S-like approach to passthrough entities. See 1986 Passthrough Entity Hearings, *supra* note 8, at 15, 36 (statement of Mentz); Goodley, Treasury Officials Discuss 1987 Act Partnership Provisions and Tech Corrections, 38 Tax Notes 432, 434 (Feb. 1, 1988) (Pearlman support for approach). Congress may also have thought that because disincorporation relief had been made available in 1982 but was little utilized, pre-1982 PSCs already had their chance to take advantage of the relief, and subsequently formed PSCs should have been on notice that the continued tax benefits of PSCs would someday be ended.

¹¹¹ For authorities and development of classification regulations, see Sexton & Osteen, *supra* note 9; Rustigan, Effect of Regulation Definitions on Real Estate Syndicates, 19 N.Y.U. Inst. on Fed. Tax'n 1065 (1961).

¹¹² *Morrissey v. Commissioner*, 296 U.S. 344, 359 (1935). The predecessor to the Tax Court mechanically applied the *Morrissey* factors in determining status of a family limited partnership, when the Service sought corporate reclassification instead of generic reallocation arguments. See *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942), acq. 1942-2 C.B. 8. *Glensder Textile* has been criticized, see Peel, *supra* note 9, at 99, but unfortunately became the model for the limited partnership provisions of the final 1960 *Kintner* regulations. In *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1, the Tax Court majority suggested that the *Kintner* regulations be revised to reflect more faithfully the *Morrissey* resemblance approach, disapproving of the "thumb on the scales" in favor of partnership treatment requiring that the entity possess three of the four corporate characteristics and that these characteristics were to be equally weighted. See 66 T.C. at 185. The proposed and withdrawn 1977 regulations were intended as a response to this criticism. See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 7, n.8.

¹¹³ See Treas. Reg. § 301.7701-2(b). The Board of Tax Appeals in *Glensder Textile*, *supra*, mechanically extended the *Morrissey* focus on technical entity classification under local law, for example, whether the organization dissolved upon the death, retirement, or incapacity of the general partner, or where a surviving general partner could elect continuation in such event. The Board reasoned that "continuity is not assured by this power [power of surviving general partner to elect continuation], for it is one vested in the several general partners,

ment,¹¹⁴ (3) limited liability of the owners,¹¹⁵ and (4) free transfer-

apparently, and not in the partnership as an entity." 46 B.T.A. at 185.

The early professional corporation cases went the opposite way, finding continuity by agreement despite dissolution under local law. See *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936); *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). Not surprisingly, the current *Kintner* regulations adopt a technical dissolution without regard to contingent continuity life test. See Treas. Reg. § 301.7701-2(b)(3). The Tax Court majority in *Larson*, 66 T.C. at 175, suggested administrative substitution of a "termination of the business" standard encompassing the life of the enterprise. The 1977 Service proposals did so, fleshing out that standard. See Prop. Treas. Reg. § 301.7701-2(d)(2), 42 Fed. Reg. 1041 (1977). First, a majority interest would have had the power to prevent interruption of business operations despite a local law dissolution due to change in status or identity of one or more members, if in such event that interest could preclude liquidation and withdrawal of capital, and withdrawal of capital would significantly impair the continuation of the business. See *id.* § 2(d)(2)(i). (Under examples the withdrawal of forty percent would impair but twenty percent would not. See *id.*) Secondly, following the advanced letter ruling requirements of the early 1970s, Rev. Procs. 72-13, 1972-1 C.B. 735; 75-16, 1975-1 C.B. 676, while overturning this aspect of the Court of Claims decision in *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975), the 1977 proposals would have found continuity of life where the only general members were corporations controlled by one or more of the limited members. See Prop. Treas. Reg. § 301.7701-2(d)(ii), 42 Fed. Reg. 1041 (1977).

¹¹⁴ See Treas. Reg. § 301.7701-2(c). Here too the *Kintner* regulations following the formalistic *Glensder Textile* approach distinguish centralized control in the general partner of a limited partnership from corporate centralized control subject to the control of shareholders so long as the general partner owns a "meaningful" or substantial proprietary interest and is not removable by the limited partners. If the general partner fails either test under *Glensder Textile* or both under the *Kintner* regulations, the general partner's management was in a "representative capacity," a corporate characteristic. See *id.*; 46 B.T.A. at 185.

The 1977 proposals basically would have adopted the *Kintner* regulations' focus on representative capacity, but would have restored the disjunctive insubstantial interest or removable standards. See Prop. Treas. Reg. § 301.7701-2(e)(1), 42 Fed. Reg. at 1041 (1977). Nevertheless, this residuum of the mechanical *Glensder Textile* approach still ignores the reality that

[m]anagement is in reality equally centralized whether a general partner has a personal stake or not. The general partner has the same fiduciary duties to the limited partners regardless of the size of his own investment. Not only does the extent of his holding have little practical import for a limited partner, it is not a feature which empirically distinguishes limited partnerships from corporations. Even in many large publicly traded corporations, it is quite common for an officer or director to own a large portion of the equity.

Note, Tax Classification of Limited Partnerships, 90 Harv. L. Rev. 745, 752 (1977) [hereinafter Tax Classification] (footnotes omitted).

¹¹⁵ See Treas. Reg. § 301.7701-2(d). The *Kintner* regulations once again extended a mistake made in *Glensder Textile*. Talking in generalities, the Board of Tax Appeals in *Glensder* noted that resemblance to corporate form would be great where "the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners. . . ." 46 B.T.A. at 183. The better reading of the *Kintner* regulations required both insubstantial assets and control by the limited partners. The Tax Court in *Larson* did not address the appropriateness of these regulations. The Court of Claims in *Zuckman* went further, as *Glensder Textile* had inti-

ability of ownership interests.¹¹⁶ Tax administrators have sought to

mated, and applied a "Catch-22" logic against the Commissioner. If the general partner had an insubstantial interest or acted only as a dummy general partner, then the limited partners in effect controlled the partnership and would be liable as generals under local law. See 524 F.2d at 738. Thus the corporate limited liability factor would never be present in a limited partnership. In this context, the Service established minimum net worth floors and maximum cross-ownership of general limited partnership interest ceilings for advanced ruling purposes. See Rev. Procs. 72-13, 1972-1 C.B. 735; 74-17, 1974-1 C.B. 438. See generally Tax Classification, *supra* note 114, at 754-55.

The 1977 proposals and various commentators would base limited liability upon a comparison of the interests subject to personal liability and those not, looking at practical liability. See Prop. Treas. Reg. § 301.7701-2(f)(2), 42 Fed. Reg. at 1041-42; Postlewaite, Dutton & Maggette, A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Geo. L.J. 423, 459-61 (1986). Thus in most traditional tax shelter limited partnerships, limited liability would be present. Some commentators would make limited liability determinative of corporate status unless the general partners hold at least a fifty percent interest in capital and losses and profits. See Postlewaite, Dutton & Maggette, *supra*, at 461. The inappropriateness of liability alone as determining separate entity or corporate status is implied in the legislative history of the Tax Reform Act of 1986. See 1986 Senate Report, *supra* note 8, at 717 (discussing material participation and liability as factors for PAL rule).

¹¹⁶ See Treas. Reg. § 301.7701-2(e). Both *Glensder Textile*, 46 B.T.A. at 184, and the *Kintner* regulations adopted a mechanical, unrealistic approach focusing on whether the limited partner had the right to assign all of his or her rights without the consent of others, thereby making the assignee the "substitute limited partner" versus the more limited power to assign profits, distributions and tax losses—surely all that the limited partner really cared about anyway. Earlier, *Glensder Textile* went even further to discount the right to transfer all partnership rights, and characterized that right as analogous to a corporate aspect, since no such transfers were in fact contemplated. See 46 B.T.A. at 186.

The 1977 proposals adopted the more practical approach of focusing on assignability of rights to share in profits and return of capital. See Prop. Treas. Reg. § 301.7701-2(g)(2), 42 Fed. Reg. at 1042 (1977). This is consistent with the case law under which an assignee partner, although not substituted, constitutes a partner for tax purposes. See *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971). Thus transferability of interest, a purported corporate factor, would generally be considered present.

As early as 1975, the Joint Committee Staff proposed, as part of an anti-tax shelter campaign, corporate treatment for any partnership with membership units registered as a public offering with the Securities and Exchange Commission. See Staff of Joint Comm. on Taxation, 94th Cong., 1st Sess., Tax Shelters: Use of Limited Partnerships, Etc. 12, 13 (1975). The House Ways and Means Committee failed to act on this and a similar 1978 proposal. See Peel, *supra* note 9, at 1004. President Carter's 1978 tax proposals then advocated a numerical ceiling on the number of limited partners, roughly corresponding to the then S corporation ceiling on number of shareholders as a determinant for corporate treatment. See *supra* note 9. In 1983, the Senate Finance Committee Staff, following an earlier draft of the ALI Federal Income Tax Project, Subchapter K 383, 392 (1984), proposed that limited partnerships with partnership interests publicly traded on an established securities market be treated as corporations. See Preliminary Subchapter C Report, *supra* note 9, at 80. This proposal generated more political interest than any other provision. See Reform of Corporate Taxation Hearings, *supra* note 9, at 7-8 (remarks of Chairman Dole). Treasury opposed the proposal this time principally because classification went beyond the scope of Sub-

quantify the degree of resemblance that requires corporate treatment.¹¹⁷ However, the Joint Committee staff believes, correctly, that the presence of these factors only overlaps the passive/active participation-by-owners dichotomy which supports separate entity treatment.¹¹⁸ Ironically, most large limited partnerships manifest

chapter C simplification. See *id.* at 11 (statement of Assistant Secretary for Tax Policy Ronald Pearlman). However, it set the standard for later study.

Questions such as how a type of organization should be taxed, whether a so-called C-corporation, an S-corporation or as a partnership or, for that matter, as a real estate investment trust or a regulated investment company, require, we believe, an analysis of all of those classification situations. We suspect that if that analysis were undertaken, we would not agree to base tax classification on the degree of marketability of an organization's equity interests.

Id. at 11 (statement of Ronald Pearlman).

¹¹⁷ Prior to the *Kintner* regulations, the Service for ruling purposes held that an organization would not be treated as an "association" if any *one* of the four essential characteristics—(1) associates, (2), objective to carry on a business and divide its profits, (3) centralized management, and (4) continuity of life—were not present. See I.T. 3930, 1948-2 C.B. 126; Rev. Rul. 57-341, 1957-2 C.B. 884; Rev. Rul. 57-607, 1957-2 C.B. 887; I.T. 3948, 1949-1 C.B. 161; Rev. Rul. 54-484, 1954-2 C.B. 242. The *Kintner* regulations, in order to provide certainty and weight the balance against corporate status, according to some, made corporate treatment turn on the presence of three or more of the four corporate resemblance factors. Thus this "thumb upon the scales," *Larson*, 66 T.C. at 185, contrary to conventional wisdom, was *not* designed to stop corporate tax treatment for professionals, but instead was intended to provide certainty and liberalization of the prior Service requirement of four out of four corporate requirements (which varied from the *Kintner* listing). See *supra* note 113 for a discussion of *Larson*.

The 1977 proposed amendments adopted the *Morrissey* resemblance test, specifically abandoning the *Kintner* three-out-of-four factors to be a corporation in favor of a preponderance test. Thus, the proposed amendments illustrated "how classification [was] determined when an organization resembles a corporation with respect to two of the four characteristics but not with respect to the other two." Notice of Proposed Regulations, 42 Fed. Reg. 1039 (1977). The examples set forth in the proposed regulations made use of a sophisticated weighting system such as called for in *Larson*. See Prop. Treas. Reg. § 301.7701-2(h), 42 Fed. Reg. at 1042-44 (1977); *supra* note 113.

The 1977 proposals would have classified most tax shelter limited partnerships as associations and, therefore, are much broader than the OBRA PTP provisions. This article argues that the broader approach is more appropriate than narrow publicly traded factor. However, the fundamental defect in the four factor resemblance approach is that the factors only indirectly reflect the underlying policy: limitation of aggregate pass through to owners who materially participate.

¹¹⁸ The Joint Committee Staff and commentators have come to recognize that whether an entity should be treated as a separate taxable unit should turn on the relationship between the individual and its owners. "In particular, to the extent that an entity is viewed as acting separately from its owners, rather than merely as their agent or alter ego, an argument can be made that it should be treated as a separate taxable unit." Passthrough Entity Hearing Pamphlet, *supra* note 8, at 13. See Sheppard, *Walk This Way*, 35 Tax Notes 86, 87 (April 6, 1987); Faber, *Entity-Level Taxation: Drawing the Line*, 35 Tax Notes 413 (Apr. 27, 1987).

all four characteristics,¹¹⁹ whereas most close corporations possess none;¹²⁰ hence the misplacement of both on the tax entity

The underlying policy question is whether the owners are the parties that actually earn the income of the entity in a realistic and substantial economic sense. This determination should turn in large part on whether the owner is active in management. See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 14-15. The 1977 proposed amendments themselves identify the core of the partnership as this aggregate characteristic.

A partnership is usually characterized by the partners' personal identification with the partnership, their personal participation in its decision-making, and their personal responsibility for its obligation.

Prop. Treas. Reg. § 301.7701-2(a)(2), 42 Fed. Reg. at 1040 (1977), withdrawn, 42 Fed. Reg. 1489 (1977). The basic problem is that a limited partnership generally does not have this participation characteristic, and the four factors are not directly tied into this policy of basing corporate treatment on participation.

¹¹⁹ See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 16-17; 1986 Passthrough Entity Hearing, *supra* note 8, at 19, 28 (statement of Mentz); 1987 Senate MLP Hearings, *supra* note 7, at 50 (statement of Mentz). For industry counterarguments, see 1987 Senate MLP Hearings, *supra* note 7, at 110-11 (statement of Lewis Sandler) (large limited partnerships do not possess continuity of life and limited liability). Others have pointed to the functional differences between large limited partnerships and corporations in cash-flow yield and in the diversity of the enterprise. See *id.* at 89, 167-68 (statements of James Moffett and Barry Miller). Such traditional uses of the partnership are by and large covered by the passthrough PTP exception, but the more recent trend to active, continuing business partnerships requiring reinvestment, see Sheppard, *supra* note 72, at 1255, will generally result in such partnerships not passing the 90% passive-type income or natural resource development requirement.

¹²⁰ See 1986 Passthrough Entity Hearings, *supra* note 8, at 19, 28 (statement of Mentz), 43, 51 (statements of McKee and Kuller). First, notwithstanding the perpetual continuity of a corporate charter, when an active principal dies, the business will terminate or be sold unless management succession has been or can be soon arranged. See generally Kessler & Yorio, *Choosing the Appropriate Form for the Small Business*, 1 Corp. L. Rev. 291, 298 (1978). In close C corporations with very narrowly held stock, key shareholders are also often members of the board of directors and/or 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. Similarly, limited liability is often a chimera for close C corporations. Significant third party creditors (except perhaps in real estate ventures) usually require guarantees by principal shareholders and their spouses. See 1986 Passthrough Entity Hearing, *supra* note 8, at 19 (statement of Mentz); The Subchapter S Revision Act of 1982: Hearings on H.R. 6055 before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm., 97th Cong., 2d Sess. 263 (1982) [hereinafter *Subchapter S Revision Hearings*] (statement of Chairman Stark); Kessler & Richmond, *Has Congress Made the C Corporation Obsolete for the Small Business?*, 7 Corp. 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 the supervision of others. See Kessler & Yorio, *supra*, at 302-04. The assets of the corporate business itself, always subject to the entity's liabilities, are often the principal asset of the entrepreneur. Close corporations also miss the mark as far as free transferability is concerned, as there is a real problem in finding any secondary market at all for minority close C corporation stock. A buy-sell option

continuum.¹²¹

Currently the only policy-based, functional entity classification distinction is between an aggregate approach, which treats an entity as a collection of its owners banded together for profit and treats the owners as if they owned proportionate shares of the entity's assets,¹²² and a separate entity approach under which owners have an interest only in the entity and not in its assets.¹²³ A separate entity approach does not necessarily mandate a double taxation regime. Integration of a separate entity's income (or loss) with its owners' income turns on other policies.¹²⁴ Under a deep structure analysis, the aggregate approach treats the owner of an interest in an entity as an entrepreneur owning a portion of the entity's assets and earning a portion of its income, all apart from the entity which in turn serves only as a mere collection, reporting and audit device.¹²⁵ Current Subchapter K, which deals with taxation of partnerships, roughly reflects this distinction,¹²⁶ but allows a part-

with the corporation and/or co-shareholders and right of first refusal are standard.

¹²¹ See *supra* note 8 and accompanying text. More significantly, PTPs are not functionally aggregates and PSCs are not functionally separate entities.

¹²² See *Holiday Village Shopping Center, Inc. v. United States*, 5 Cl. Ct. 566, 570 (1984), *aff'd*, 773 F.2d 276 (Fed. Cir. 1985). See Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. Inst. on Fed. Tax'n 287 (1961); Fellows, *Partnership Taxation: Confusion in Section 762(b)*, 32 Tax L. Rev. 67 (1976).

¹²³ Most commentators have focused on the owner's interest in the business as to character of income. See Wolfman, *supra* note 122, at 288; Fellows, *supra* note 122, at 79.

¹²⁴ See *infra* notes 176-189 and accompanying text.

¹²⁵ See S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954) [hereinafter 1954 Code Senate Report]; Department of Treasury, *The President's 1978 Tax Program* 118 (January 30, 1978), reprinted in 1978 House Hearings, *supra* note 23, at 277 (1978); *Pratt v. Commissioner*, 550 F.2d 1023, 1026 (5th Cir. 1977). See generally, Lane, *Sol Diamond: The Tax Court Upsets the Service Partner*, 46 So. Cal. L. Rev. 239, 253-61 (1973). Cf. Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 238 (1985); *Holiday Village Shopping Center*, 773 F.2d at 282.

¹²⁶ Subchapter K is generally described as manifesting a hybrid or mix of "entity" and "aggregate" features, see *Bennet v. Commissioner*, 79 T.C. 470, 479 (1982), (citing *I W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners* ¶ 1.102 (1977)); J. Crane & A. Bromberg, *Law of Partnership* 16-29 (1968), with the relative emphasis shifting according to the prevailing legal thought at the time. See Canellos, *supra* note 24, at 1006. However, the legislative history and background of Subchapter K, as well as the better reasoned decisions, establish that the aggregate core predominates. See *supra* note 125. The mandatory entity features are properly and largely limited to determining and reporting income and more recently, audit. See 1954 Code Senate Report, *supra* note 123, at 93. See *infra* note 127.

nership to elect entity treatment for some purposes. This election feature is intended to simplify transactions for large businesses,¹²⁷

The aggregate approach rests on a view of a partnership for tax purposes as a collection of individuals banded together for a profit. See Weidner, Pratt and Deductions for Payments to Partners, 12 Real Prop. Prob. & Tr. J. 811, 812 (1977); H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); *Holiday Village Shopping Center*, 5 Cl. Ct. at 571 (1984); 1953 House Hearings, *supra* note 31, at 1369 (statement of Mark Johnson for the American Bar Association, Section of Taxation); 1978 House Hearings, *supra* note 23, at 277 (statement of Treasury representative). Functionally, the aggregate approach endeavors to tax a partner "in the same manner as if there were no partnership." H.R. Rep. No. 2543, 83d Cong., 2d Sess. 58 (1954) [hereinafter 1954 Code Conference Report]. See 1954 Code Senate Report, *supra* note 125, at 93. Aggregate passthrough taxation is the functional equivalent of direct or single taxation of the owner-partner, according him or her "the same tax consequences which would be accorded an individual entrepreneur." 1954 Code Senate Report, *supra* note 125, at 99. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 71 (1954) [hereinafter 1954 Code House Report]; Lane, *supra* note 125, at 259-60. The aggregate approach essentially treats the partnership form of doing business as no more than a recordkeeping or accounting convenience. See 1954 Code House Report, *supra*, at 65; 1953 House Hearings, *supra* note 31, at 1370, 1378 (statement of Mark Johnson); 1959 Advisory Group Hearings, *supra* note 23, at 20 (statement of Willis) (use of aggregate approach to determine character "is carrying through the basic concept of the partnership, that it is in a very substantial sense an aggregate of individuals and we are taxing income back to them and we use the partnership merely as a pooling source of information"), 27.

The drafters of the 1954 ALI draft revision of the tax treatment of partnerships and partners explained that the "basic pattern" of the draft was "to treat the partnership as a conduit through which the individual partners are regarded as receiving the income computed by the partnership as if they had earned it individually." 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, 113-14 (1954) [hereinafter ALI Partnership Proposals]. The rationale of this aggregate approach in the 1954 Code, however, was not based on policy so much as "on the assumption that this approach most nearly conforms to the understandings of the parties of the usual small business." *Id.* at 113; 1953 House Hearings, *supra* note 31, at 1370 (statement of Mark Johnson for the American Bar Association, Section of Taxation). However, later administrative developments centered on the participation policy basis for the aggregate approach. The Service's aborted 1977 proposed revision of the entity classification regulations, which would have classified most limited partnerships as associations taxable as corporations reveals the policy basis for aggregate passthrough taxation. See *supra* note 118. After this unsuccessful attempt to deny the limited partnership vehicle to tax shelters, the next administration shifted in 1978 to a legislative proposal to treat a limited partnership with more than fifteen limited partners as a corporation tax purposes. See 1978 House Hearings, *supra* note 23, at 11. The stated purpose of the 1978 proposals was to end the use of syndicated partnerships as tax shelter vehicles, see *id.*, but the Treasury explanation also looked to the aggregate policy underlying current Subchapter K. Treasury pointed out that the Code treatment of "a partnership largely as an aggregate of individuals" was intended to offer flexibility, "and to preserve some degree of individuality, for the members of small partnerships." *Id.* at 277. Treasury believed that large syndicated partnerships with many passive investors, however, complicated the law and were both unnecessary and inappropriate. See *id.*

¹²⁷ Although the 1954 ALI partnership proposals generally treated partners "as co-owners

of the partnership property, . . . in the interest of flexibility . . . a series of elective rules based upon the entity theory [were] provided to take care of those partnerships which have had numerous partners or a complex variety of assets." ALI Partnership Proposals, *supra* note 126, at 113. In presenting these views to the House Ways and Means Committee, Mark Johnson, testifying on behalf of the American Bar Association's similar proposal, argued that all of the rules, whether entity or aggregate based, should be tied together in a single, coordinated pattern affording predictability. Establishment of some set of clearly-defined rules was more important than developing any one particular set of rules, entity or aggregate. See 1953 House Hearings, *supra* note 31, at 1369-71 (statement of Johnson and colloquy with Representative Mason); Rabkin & Johnson, *The Partnership Under the Federal Tax Law*, 55 Harv. L. Rev. 909, 949 (1942).

Against this background, the House, while generally following the ALI proposals, by-and-large chose the *entity* approach in the interest of simplification of the partnership provisions as to transfers of interests, pro rata allocations of built-in gains and losses, distributions of property, self-dealing, and in part retirement payments with limited elective aggregate features, generally affecting all partners, and an ordinary income partial aggregate override as to transfers of partnership interests and certain distributions. See 1954 Code House Report, *supra* note 125, at 67.

In Hearings on the Internal Revenue Code of 1954 before the Senate Finance Committee, testimony by the ABA representatives criticized the various entity theory choices of the House Bill and recommended enactment of a provision "setting forth a general rule as to whether the aggregate or entity theory of partnerships is to be applied in areas not specifically covered by statutory provisions." Hearings on H.R. 8300 (the Internal Revenue Code of 1954) before the Senate Finance Comm. Part 1, 83d Cong., 2d Sess. 459 (1954) [hereinafter 1954 Senate Code Hearings] (Report of ABA Section of Taxation). See also ALI Partnership Proposals, *supra* note 126, at 170. The ABA also recommended that as to many of the areas where the House chose an entity approach, it ought to instead follow the ABA and ALI Draft and provide entity-aggregate elections. See 1954 Senate Code Hearings, *supra*, at 460-70. The Senate Bill and ultimately the Conference Bill responded to these requests, and while in many instances the bills adopted the House's entity rules for simplicity, they also provided elections for "use of the so-called aggregate rule." 1954 Code Senate Report, *supra* note 125, at 90. The Senate and the Conference bills followed more of an aggregate approach as to contributions and distributions. See *id.* at 93, 97, 95-96, 98-99. See generally Jackson, Johnson, Surrey, Tenen & Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183 (1954) [hereinafter *The Code of 1954: Partnerships*]. Furthermore, the 1954 Code Conference Report states that while the 1954 Code uses an "entity" approach in section 707 transactions, "[n]o inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." 1954 Code Conference Report, *supra* note 126, at 59. The Conference Report also provides an illustration contained in the ABA Section of Taxation Report to the Senate Finance Committee. Compare 1954 Senate Code Hearings, *supra*, at 459.

In summary, the 1954 ABA and ALI proposals generally adopted the aggregate approach as the standard approach, particularly for small businesses, but allowed an elective entity approach as to certain transactions for simplicity with large businesses in mind. See *The Code of 1954: Partnerships*, *supra*, at 112-13; 1953 House Hearings, *supra* note 31, at 1369-71 (statement of Mark Johnson for the ABA). Carrying simplicity further, the House bill further would have applied an entity approach particularly as to shifts in interests allocations and inside adjustments arising from and in-kind distributions. Subchapter K as en-

but is based upon unsound policy considerations.¹²⁸ Subchapter S instead (ostensibly for the sake of simplicity,¹²⁹ but more likely to encourage C to S corporation conversions¹³⁰) provides a pass-through separate entity approach, which hardly produces simplicity in actual operation and often creates inequities or business planning hardships.¹³¹ These more subtle horizontal non-pass-

acted by-and-large returned to the ABA-ALI model in this context, but reversed the elections so that the entity approach was the standard with an elective aggregate approach. In essence Subchapter K still follows an aggregate approach.

¹²⁸ The premise of the 1954 ALI-ABA drafts was that Treasury was merely an arbitrator or stakeholder as to such partnership tax policy issues under the rationale that either the entity or the aggregate approach would in the long run produce about the same amount of taxes, because the only question was which partner was to be taxed and when. See 1953 House Hearings, *supra* note 31, at 1369-70 (statement of Mark Johnson). The time value of money and low tax high income taxpayers proved this premise erroneous. Indeed, thirty years later, the 1984 partnership tax revisions largely reversed the various tax consequences of this premise.

¹²⁹ Chairman Mills in 1959 Hearings on Subchapter K viewed the Subchapter S entity approach as to characterization of income passthrough as a simplification for the convenience of small taxpayers. See 1959 Advisory Group Hearings, *supra* note 23, at 13; S. Rep. No. 1983, 85th Cong., 2d Sess. 88 (1958), reprinted in 1958-3 C.B. 1009 (modified entity approach as to passthrough of income, i.e., ordinary income to shareholder except for capital gains "adopted so that this provision can operate in as simple a manner as possible").

¹³⁰ See Compendium, *supra* note 23, at 1742. The overwhelming majority of the first S Corporation elections were by taxpayers which had previously reported as C corporations. See 1959 Panel Discussions, *supra* note 23, at 92 (statements of Karl Price and Chairman Mills), probably reflecting the paradigm 1954 Code tax life cycle of a corporation beginning with an S election during the initial loss stage. See Compendium, *supra* note 23, at 1726, 1741 (statement of Driscoll); Carlin, *Partnership v. Corporation; Non-Tax Shelter Business Enterprise*, 34 N.Y.U. Inst. on Fed. Tax'n 741, 749-51 (1977); Kanter, *To Elect or Not Elect Subchapter S—That is a Question*, 60 Taxes 882, 917 (1982); Kessler & Yorio, *supra* note 120; O'Connor, *Selection in the Form of Business or Professional Organization: A Need for Clairvoyance*, 56 Taxes 880, 884-85 (1978). Once the profit stage is reached, the S election is then terminated and the organization operates as a C corporation to accumulate earnings taxed at lower graduated corporate rates. See Compendium, *supra* note 23, at 1686-87, 1726 (statements of Janin and Caplin); Dial, *When to Put Real Estate in a Corporation—Tax Considerations*, 32 S.C. L. Rev. 319, 328-29 (1980); Mullaney & Blau, *An Analytic Comparison of Partnerships and S Corporations as Vehicles for Leveraged Investments*, 59 J. Tax. 142, 148-49 (1983); O'Connor, *supra*, at 885. But see Kessler & Richmond, *supra* note 120. Finally, S status is again elected, generally at least five years after termination, see I.R.C. § 1362(g), when accumulated earnings or unreasonable compensation problems arise. See Compendium, *supra* note 23, at 1741 (statement of Nicholson); Starr, *S Corporation: Is It the Right Choice?*, 43 N.Y.U. Inst. on Fed. Tax'n 5-1, 5-36 (1985). In short, deep policy had not yet prevailed.

¹³¹ See Coven & Hess, *The Subchapter S Revision Act: An Analysis and Appraisal*, 50 Tenn. L. Rev. 569, 622-31, 647-57, 666-70, 694-94, 702-06 (1983) (discussions of income determination and character of income; allocations of income; entity level debt and loss pass-through; cash distributions; owner retirements; and distributions of appreciated property);

through disparities between Subchapters K and S create traps for the unwary and tax planning opportunities for the aware¹³², which is bad, if lucrative, tax policy.¹³³

At the deep structure level, the hallmark of an entrepreneurial situation requiring aggregate passthrough treatment is the interest-holder's active, or "material," participation in the business¹³⁴

Coven, Subchapter S Distributions and Pseudo Distributions: Proposals for Revising the Defective Blend of Entity and Conduit Concepts, 42 Tax L. Rev. 381 (1987); Eustice, *supra* note 8, at 353-54, 362-67, 372-78, 381-94, 396-400, 404-10, 433 (discussions of aggregate vs. entity overview, capital structure limitations; income character limitations; entity level treatment; ordinary distributions; liquidating distributions and sales; inside asset basis adjustments; conversions of status and form; outside basis for loss; extraordinary distributions; sales of owner interests; comparison of Subchapters C, S and K).

¹³² See Eustice, *supra* note 8; Greenberg, Form of Organization for Holding and Developing Real Estate, 29 N.Y.U. Inst. on Fed. Tax'n 1129 (1971); Mullaney & Blau, An Analytic Comparison of Partnerships and S Corporations as Vehicles for Leveraged Investments, 59 J. Tax 142 (1983); Thompson, Tax Policy Implications of Contributions of Appreciated and Depreciated Property to Partnerships, Subchapter C Corporations and Subchapter S Corporations in Exchange for Ownership Interests, 31 Tax L. Rev. 29 (1975).

¹³³ See Staff of Joint Comm. on Taxation, Staff Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations 8 (Comm. Print 1980) [hereinafter Staff S Recommendations]; Subchapter S Revision Hearings, *supra* note 120, at 71 (statement of David Glickman, Deputy Assistant Secretary for Tax Legislation).

Unfortunately, the approximately 20-year history of subchapter S attests to many traps for those not extremely familiar with its provisions. The traps most often fall into involve: (1) unintentional violation of the continuing eligibility rules (particularly the restriction on passive investment income), resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax free distributions of previously taxed income; and (3) a shareholder having an insufficient basis to absorb his share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The 20-year history of subchapter S also indicates that knowledgeable taxpayers and tax counsel have derived some unintended benefits from the subchapter S provisions. Examples of these benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

The Staff has reviewed subchapter S from the perspective of simplifying its operation (particularly in the area of distributions), removing both the traps for the unwary and the few unintended tax avoidance benefits, and eliminating (where practical) some of the unwarranted differences in tax consequences under the partnership and subchapter S provisions.

Staff S Recommendations, *supra*, at 8 (footnote omitted).

¹³⁴ See *supra* note 12; *supra* note 125; Passthrough Entity Hearing Pamphlet, *supra* note 8, at 14-15, 17 (criterion for separate entity treatment whether owners have full control over process of earning income or over use and disposition of amounts earned by the entity); cf. 1986 Senate Report, *supra* note 7, at 717.

and perhaps, in a small enough venture, his acting as the financier.¹³⁵ Basing aggregate passthrough treatment on a reasonable numerical ceiling on the number of owners or size of the enterprise instead would achieve rough justice and would be infinitely easier to administer.¹³⁶

Measured against this conceptual framework, the pre-OBRA tax treatment of both PTPs and most close C and S corporations was wrong. Prior law, inappropriately relying on state law classification,¹³⁷ largely treated PTPs (whose limited partner owners do not materially participate) as aggregates, creating some administrative difficulties,¹³⁸ but far greater tax policy conflicts. Under a deep

¹³⁵ The United States Supreme Court in *Commissioner v. Tower*, 327 U.S. 280, 286 (1946), stated that a partnership is created "when persons join together their money, goods, labor or skill for the purpose of carrying on a trade, profession or business and when there is community of interest in the profits and losses." *Id.* (footnote omitted). See also *Commissioner v. Culbertson*, 337 U.S. 733, 740 (1949) (quoted definition in *Tower* constitutes application of standard definition of income "—the gain derived from capital, from labor, or both combined—to a particular form of business organization") *Id.* (footnote omitted).

¹³⁶ The Department of Treasury in 1978 supported a numerical reclassification rule with an aggregate analysis. See 1978 House Hearings, *supra* note 23, at 277. A material participation standard would be very difficult to apply according to a witness at the House MLP hearings. See House MLP Hearings, *supra* note 16, at 357-58 (statement of Lewis Sandler). The detail presented in the first wave of PAL regulations suggests that a numerical test would be far easier to administer. See Prop. Treas. Reg. § 1.469 OT - 11T, 53 Fed. Reg. 5686-5732 (1988). Alternatively, a size test of earnings or assets would also be easier to administer. Professor Ginsburg opposes both an active business criterion and a numerical test. See 1986 Passthrough Entity Hearings, *supra* note 8, at 72 (statement of Prof. Ginsburg).

¹³⁷ See *supra* notes 38, 120.

¹³⁸ The ALI 1984 Subchapter K study lists some of the administrative problems with taxing publicly traded corporations under a system like Subchapter K. See ALI, Federal Income Tax Project, Subchapter K, Proposals of the American Law Institute on the Taxation of Partners 384 n.39 (1984) (The ALI study derived this list of problems from McLure, Must Corporate Income be Taxed Twice? 154-66 (1979)). But procedural amendments authorizing entity-level audits of passthrough entities, nominee reporting and computer software programs have answered most of these objections, or so industry spokespersons claim. See 1987 House MLP Hearings, *supra* note 16, at 38 (statement of Mentz) (computer software), 75-76 (statement of Herbert Lerner) (daily allocation problems), 87 (statement of John Jones, Chairman of ABA Section of Taxation) (fungibility of units traded), 205-209 (statement of James Lovett of Coopers & Lybrand) (nominee reporting and computer software); 1987 Senate MLP Hearings, *supra* note 7, at 53 (statement of Mentz), 134-35 (statement of John Neafsey of Sun Company, Inc.), 217 (statement of an American Institute of Certified Public Accountants representative as to "simplifying assumptions"); Keyser, *supra* note 12, at 10-3; McKee, Master Limited Partnerships, 45 N.Y.U. Inst. on Fed. Tax'n (Part I) 23-1, 23-14-15 (1987). The reality seems to be that most problems arose from the termination rule of section 708, I.R.C. § 708, and attendant revaluation of capital accounts under Treasury Regulation 1.704-1(b)(2)(iv)(e), and the meshing of inside basis adjustments under I.R.C. §§ 742, 755, upon transfers of partnership interest with the marketing goal that

structure analysis, PTPs and similar large, limited partnerships should be treated as separate entities if most of their owners do not materially participate.¹³⁹

Conversely, prior law, relying equally on form,¹⁴⁰ incorrectly treated a small, usually close C corporation in which most of the owners materially participated as a separate tax entity (with a

all interests be fungible, that is, that they carry the same "inside" basis adjustment. See 1987 Senate MLP Hearings, *supra* note 7, at 181 (statement of Richard Cohen); Marich & McKee, Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships, 41 Tax L. Rev. 627 (1986). Committee Chairman Rangel did not believe that administration of MLP's was the major problem. See 1987 House MLP Hearings, *supra* note 16, at 247.

Ironically, the drafters of the 1954 Code probably assumed that large entities would choose the entity approach here for simplicity. See *supra* note 127. Certainly Treasury is correct that the aggregate treatment found in some Subchapter K provisions is inappropriate as a matter of tax policy where the owners do not materially participate. See 1978 House Hearings, *supra* note 23, at 277 (Treasury explanation of Carter Administration Proposals).

¹³⁹ See *supra* note 134 and accompanying text.

¹⁴⁰ The *Kintner* classification regulations define unincorporated organizations treated as "associations taxable as corporations," as distinguished from partnerships, limited partnerships or trusts. Implicit in this approach and the reliance upon local law for establishing legal relationships is that "the artificial entity usually known as a corporation," is treated as a corporation for tax purposes. Treas. Reg. § 301.7701-1(c). Thus, state law corporate form is respected as long as the "corporation" was formed or used for a business purpose. See 1986 Passthrough Entity Hearings, *supra* note 8, at 28 (statement of Mentz); *Strong v. Commissioner*, 66 T.C. 12 (1976), *aff'd*, 553 F.2d 94 (2d Cir. 1977). While functionally close corporations are indistinguishable from sole proprietorships or partnerships depending on the number of shareholder-employees, courts refuse to look at substance, probably reasoning that since "incorporation" and the legal entity are all matters of form, see *Keller v. Commissioner*, 77 T.C. 1014, 1024, 1031 and n.20 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983), changes should be made by the legislature.

The Supreme Court recently allowed the owners (a limited partnership) of a "nominee" corporation (holding the title and signing the mortgage) to treat property titled in the nominee corporation's name as owned by the shareholder who might enjoy its tax losses, "when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset." *Commissioner v. Bollinger*, 108 S.Ct. 1173, 1179 (1988). A more direct and forthright approach would have been to disregard the nominee corporation for tax purposes due to the shareholder's control. That, of course, would have overturned *sub rosa* *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), as well as *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949). As it is, the Court has given renewed life to a legal fiction of agency in this context that the taxpayer may use. But cf. *Spector v. Commissioner*, 641 F.2d 376 (5th Cir. 1981) (while Commissioner may challenge and look through the chosen form of a transaction as lacking economic reality, taxpayer may not do the same, absent a showing of unjust results).

lower inside tax rate on its retained earnings).¹⁴¹ Considerations of horizontal and vertical equity, as well as economic efficiency, mandate that both a close C and an S corporation in which most of the owners materially participate be treated as an aggregate of its owners as to income and losses.¹⁴² Deep structure analysis also requires an aggregate approach as to ownership shifts, liabilities, contributions and distributions.¹⁴³ In both cases, the current entity pass-through approach has not yielded the anticipated simplicity and should be discarded for S corporations.

Although the OBRA PTP and PSC provisions suffer from frequent technical¹⁴⁴ and occasional conceptual deficiencies,¹⁴⁵ they are fundamentally aimed at the proper target of tax treatment on the basis of a deep structure analysis of organizational form. The problem lies not in the aim, then, but in the scope: the provisions are too restricted in that they fail to treat large limited partnerships consistently with PTPs and inequitably tax corporate PTPs and their owners more heavily than large C corporations and their shareholders combined, creating schedular horizontal distortions in both cases. Moreover, large limited partnerships and passthrough PTPs inappropriately retain aggregate Subchapter K treatment, causing administrative and policy problems; and the corporate tax treatment of actively participating owners in non-professional close corporations continues to contravene deep structure ideals.

¹⁴¹ For criticism of this result, see 1987 House MLP Hearings, *supra* note 16 at 341, 346-347 (statement of John Lee); 1978 Senate Hearings, *supra* note 7, at 136 (statement of Blumenthal); 1978 House Hearings, *supra* note 23, at 3517-19 (statement of Dr. Gaffney), 6240-42 (statement of Rep. Mikva); 1959 Panel Discussions, *supra* note 23, at 854-55, 860-61 (statement of Paul Ziffren); Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17; Corporate Tax Reform Proposals, *supra* note 33, at 4; 1984 Treasury Proposals, *supra* note 9, at 128-29. The final result in OBRA was the repeal of the inside graduated brackets for PSCs only.

¹⁴² See *supra* note 30; McLure, *infra* note 165, at 535.

¹⁴³ In the context of close corporations most commentators have focused only on the separate taxation issue. See, e.g., Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17. However, in the 1987 House MLP Hearings, the author argued that aggregate passthrough should apply to close corporations whose owners materially participate. See 1987 House MLP Hearings, *supra* note 16, at 343-350. And Subchapter S in its still-born 1954 Senate version simply applied subchapter K, 1954 Code Senate Report, *supra* note 125, at 119, 123, as some continue to advocate. See 1986 Passthrough Entity Hearings, *supra* note 8, at 95 (statement of John Pennell).

¹⁴⁴ See *supra* notes 98-99, 105-107, and *infra* notes 189-198 and accompanying text.

¹⁴⁵ See *infra* notes 280-283 and accompanying text.

B. Integration

1. PTPs and Large Limited Partnerships: Corporate Sector Tax

The bulk of the debate concerning classification of large limited partnerships has failed to separate the issues of classification and integration.¹⁴⁶ As shown above, separate entity treatment is appropriate where most of the owners are passive, as in most large limited partnerships. However, such a separate entity should not necessarily be taxed as a separate taxpayer and its owners then taxed on distributions or other realizations of entity level profits. Where a passive-owner entity's "business" is passive, the Code traditionally has afforded conduit separate entity treatment as to income, but not losses.¹⁴⁷ OBRA in its exception from corporate treatment of PTPs of activities generating 90% passive income loosely reflects this policy,¹⁴⁸ but errs in permitting continued aggregate treatment.¹⁴⁹

The more difficult integration issue concerns a large active business with inactive owners. Treatment of an entity not formally organized as a corporation as an "association," thereby triggering two-tier corporate taxation, historically has turned on the *Morrissey* corporate resemblance factors.¹⁵⁰ But these same factors would

¹⁴⁶ See, e.g., Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17; Sheppard, *supra* note 118, at 86; Faber, *supra* note 118, at 413.

¹⁴⁷ Integration as to RICs and REITs is obtained through an entity-level dividends paid deduction with a limited passthrough of capital gains character at the owner level. See I.R.C. §§ 852(b)(2)(D), 857(b)(2)(B). Retained earnings are taxed at the entity level. See I.R.C. §§ 852(b), 857(b); Passthrough Entity Hearings Pamphlet, *supra* note 8, at 10-12, 18. These conduit entities do not pass through losses. See *supra* notes 7, 66-67. The Senate REMIC provision similarly employed a limited entity conduit with conventional dividends-paid deduction integration of income only. See 1986 Senate Report, *supra* note 7, at 796. In many ways the Senate REMIC provision appears the ideal conduit separate entity with its prescribed accounting period and method, a 100% penalty prohibited transaction provision, mandatory distribution of cash flow, and partnership-like carryover basis tax-free liquidation provisions. See *id.* at 794-800. The Conference instead provided that a "REMIC is not treated as a separate tax entity. Rather the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein. . . ." 1986 Bluebook, *supra* note 51, at 412, 417. Possibly its rationale was that the existing conduit entity models of RICs and REITs were overly detailed and inflexible. See 1987 Senate MLP Hearings, *supra* note 7, at 199 (statement of John Chapoton).

¹⁴⁸ See 1987 House Report, *supra* note 21, at 1066; *supra* notes 63-70 and accompanying text.

¹⁴⁹ See *infra* notes 280-283 and accompanying text.

¹⁵⁰ See *supra* notes 112-117 and accompanying text.

apply to most if not all large limited partnerships. The advantages afforded by the *Morrissey* corporate characteristics were once thought justification enough for the corporate income tax. The argument that the privilege of the corporate franchise¹⁵¹ is the reason for the imposition of a corporate tax is no longer suggested as the policy basis for corporate taxation, save in an attenuated fashion.¹⁵² In fact, commentators historically have had difficulty in

¹⁵¹ See Staff of Joint Comm. on the Economic Report, 84th Cong., 1st Sess., *The Federal Revenue System: Facts and Problems* 75-76 (1956) [hereinafter *Federal Revenue System*].

The proper role of the corporate income tax in the Federal revenue system has long been the subject of dispute among students of taxation. It is argued by some that the sole basis for taxing corporations is the benefit derived from the privilege of doing business in the corporate form. Exponents of this view hold that the corporate tax should properly be regarded as a franchise tax which should be imposed at rates far more modest than those in effect in recent years. Others maintain that the position of corporate enterprise in the national economy requires a more intensive use of corporate income taxation, particularly with a view to reaching monopoly profits. Between these two extremes, a widely held view is that because incorporated business controls the use of a substantial portion of the economy's resources, corporate profits are necessarily an important subject of income taxation. According to this view, corporate income-tax policy should be based on broad economic objectives such as smoothing out fluctuations in the level of economic activity and improving income distribution in order to maintain a steady rate of economic growth.

Id. See also Corporate Tax Reform Proposals, *supra* note 33, at 17-20; 1978 House Hearings, *supra* note 23, at 3419 (statement of Ernest Christian).

¹⁵² See Canellos, *supra* note 24, at 1000 ("Under the classic view, the increase in economic power represented by earnings of corporations (particularly public companies) can be considered an appropriate base for corporate taxation."); *supra* note 151. The author has always favored, at least for pedagogical rhetoric, the argument that publicly traded C corporations should be separately taxed because they disproportionately benefit from our overseas military and economic presence necessary for their penetration of markets abroad. Cf., Kies, *supra* note 51, at 188 n.42. A more balanced presentation is offered by the Joint Committee Staff:

Advocates of the two-tier tax generally argue that the corporate tax not only is a source of revenue that might not easily be replaced if the corporate tax were eliminated either directly or indirectly, but also is a tax imposed on an appropriate income base. Imposing a separate corporate income tax is supported by those who view corporations as vehicles for accumulating capital that are entities distinct from the individuals who contributed the capital and who enjoy limited liability with respect to the corporation's obligations and activities.

In many cases, corporations are viewed as not being effectively controlled by shareholders but rather by the corporate officers and directors. It is argued that it is appropriate to treat the earnings on accumulations of capital in such circumstances as a proper base of taxation. In contrast, certain corporations that may be considered as directly controlled by shareholders are permitted to elect treatment under subchapter S, which permits the S corporation to avoid being taxed as a separate entity.

Corporate Tax Reform Proposals, *supra* note 33, at 17 (footnotes omitted).

finding any benefit associated with the corporate tax.¹⁵³ (When first imposing a separate corporate income tax in 1909, Congress provided no principled analysis as to the tax policy basis for imposing the tax,¹⁵⁴ perhaps because the tax was initially *de minimis*.¹⁵⁵)

Preservation of the integrity of taxing individuals at progressive rates of tax is often offered as a policy basis for the corporate tax.¹⁵⁶ Obviously this could not have been the original congressional intent since there was no individual income tax when the

¹⁵³ See *supra* note 152; Federal Revenue System, *supra* note 151, at 75; McLure, *Integration of the Personal and Corporate Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532, 536 (1975). As Representative Noah Mason stated in the 1953 House General Revenue Revision Hearings,

When individual income taxes were down very low, we seemed at that time—and that was years ago—to favor the partnerships and proprietorships and encouraged them. They only became corporations in order to get rid of their personal liability, and so forth, and were willing to pay a little something for that privilege. But now the thing [i.e., the inside tax shelter] is reversed and it is working the other way.

1953 House Hearings, *supra* note 31, at 1368.

¹⁵⁴ Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L. J. 90, 97 and n.20 (1977). The Supreme Court, however, analyzed the 1909 excise tax as a tax on the privilege of conducting a business in the corporate form with the benefits of continuity, limited liability, centralized management, etc. See *Flint v. Stone Tracy Co.*, 220 U.S. 107, 161-162 (1911).

¹⁵⁵ See Clark, *supra* note 154. The tax rate was one percent of net income in excess of \$5,000. Payne-Aldrich Tariff Act of 1909, Ch. 6, § 38, 36 Stat. 11, 112.

Historically, no doubt, the first rather nominal corporate income taxes were motivated by a combination of the desire to raise revenue and the realistic perception of corporations as legal entities which, independent of their shareholders, bought and sold, generated large amounts of revenue and income, and reported the results. It is no accident that corporate taxes began to appear just as industrial corporations first began to occupy major independent roles in the economy. The legalistic theory of a privilege or franchise tax would not justify the present 48 percent tax, which is out of proportion to the benefit conferred. On the other hand, the demand for tax revenues has continued to increase through wars and growth in the size of government, and today corporations are larger, account for a substantial portion of the national income, and in many cases are so widely held that few shareholders have more than a minute percentage of ownership.

1978 House Hearings, *supra* note 23, at 3419 (statement of Ernest Christian).

¹⁵⁶ See 1978 House Hearings, *supra* note 23, at 3420 (statement of Ernest Christian); Graetz, *Introduction to the Edwin S. Cohen Tax Symposium: An Overview of Business Taxation*, 5 Va. Tax Rev. 577, 583-84 (1986) [hereinafter *Cohen Symposium*]; *Corporate Taxation Reform Proposals*, *supra* note 33, at 17-18; Birnbaum & Murray, *supra* note 23, at 59 (architects of 1984 Treasury Proposals believed that as an ideal, the corporate rate should not be much lower than maximum individual rate to avoid use of corporations for inside shelter).

modern corporate income tax was first imposed.¹⁵⁷ Furthermore, a far more efficient means of backstopping the individual rates would have been a mandatory passthrough of the entity's income whether or not distributed.¹⁵⁸ Indeed, as long as the *maximum* individual rate was considerably higher than the *maximum* corporate rate (until 1981), many high-bracket taxpayers actually used closely held and publicly traded C corporations as inside tax shelters.¹⁵⁹ As one student of taxation pointed out, use of corporations in such circumstances to retain earnings rendered "[t]he high rates that our tax laws now have for individuals . . . simply a facade."¹⁶⁰ While for the lower bracket individual taxpayer the burden of double taxation is far greater, so that a C corporation does not serve as an inside tax shelter for him,¹⁶¹ the reality is that the typical lower bracket taxpayer does not own corporate stock.¹⁶²

Commentators have also rationalized the inside corporate tax as a tax on the "deferral value" of not taxing the shareholders on the entity's earnings until distributed or realized through a capital transaction.¹⁶³ Given widespread deferral and realization through

¹⁵⁷ See Clark, *supra* note 154, at 97 and n.23. Indeed, in the early years in this century when the federal corporate and individual tax rates were equal, the Revenue Acts in effect provided for a shareholder-level partial dividend exclusion from the "normal" tax, recognizing that such income had already been taxed at the corporate level at the "normal rate." See Holland, *Stockholder Differential Taxation and Tax Relief*, Compendium, *supra* note 23, at 1551, 1552.

¹⁵⁸ Economists opposed full-integration because corporate sector income would then be taxed at excessive individual rates. See 1955 Tax Policy Hearings, *supra* note 7, at 554-55 (colloquy Drs. Hall and Lindner), 565 (statement of Dr. Adelman). The answer was to lower the artificially high and easily avoided individual rates. See *id.* at 521, 554-55 (statement of Harry Rudnick). Additionally, full integration would entail repeal or at least modification of the capital gains preference. See 1978 House Hearings, *supra* note 23, at 94 (statement of Blumenthal), 6144-45, 6152 (statement of Professor Graetz). Unfortunately, when all these preconditions occurred in the Tax Reform Act of 1986, the historic opportunity for complete integration (with a corporate sector imputed schedular income tax bearing the estimated corporate sector tax plus an allowance for estimated owner-level realization to be collected at the entity level) was lost, possibly because Senator Bill Bradley had not included integration in his proposals in part due to difficulty of explanations to Congressmen and voters. See Minarik, *supra* note 40, at 1365.

¹⁵⁹ See generally *supra* note 141.

¹⁶⁰ 1958 Mills Hearings (Part 3) *supra* note 23, at 3443 (statement of Paul Ziffren).

¹⁶¹ See 1978 House Hearings, *supra* note 23, at 6079 (statement of Martin Feldstein).

¹⁶² See *id.* at 6106-07 (statement of Sheldon Cohen); *supra* note 7.

¹⁶³ See 1978 House Hearings, *supra* note 23, at 3421 (statement of Ernest Christian)(contrary arguments preferred by industry witnesses); Corporate Tax Reform Proposals, *supra* note 33, at 17-18.

capital transactions (historically afforded preferential treatment),¹⁶⁴ either the inside corporate level tax, or perhaps more logically the outside shareholder level tax, could be so rationalized. But if, as has historically been the case, the combined effective inside and discounted outside tax rates are less than the effective rate of current direct taxation at the owner level (full integration)¹⁶⁵ would yield,¹⁶⁶ full passthrough would be more effective.

During the House Ways and Means Committee hearings on the President's 1978 tax program, a witness stated that "the need for tax revenues is the only reason for the [then] 48-percent nonintegrated tax on corporations."¹⁶⁷ In other words, politics, not policy, supported and supports the corporate tax. A refrain in the commentary is that the corporate tax is an easy source of revenue because it is "hidden," i.e., its incidence is unclear.¹⁶⁸ Because over 60% of taxable corporate income is earned by one-tenth of 1% of active corporations,¹⁶⁹ large C corporations are thought by popu-

¹⁶⁴ Sales and certain redemptions, see I.R.C. § 302(b), and liquidations, see I.R.C. § 331, treated as sales or exchanges and which generated capital gain, except to the extent the collapsible corporation rules of I.R.C. § 341 applied, were taxed at varying preferential rates prior to enactment of the 1986 Code.

¹⁶⁵ Full integration refers to elimination of the two-tier corporate and shareholder tax by taxation of shareholders alone on both distributed and undistributed corporate earnings.

Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level, in effect using the corporation as a withholding agent for the shareholders, or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on the allocated earnings and would adjust their basis in their shares accordingly.

Corporate Tax Reform Proposals, *supra* note 33, at 14. See generally, McLure, Integration of the Personal and Corporate Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532, 549-50 (1975) (refers to such allocation method as the "partnership method").

In contrast "partial integration" methods focus on two-tier relief only for dividends paid and generally only with respect to corporate earnings that have been taxed at the corporate level. The proposed methods by which to effect partial integration are the dividend-received exclusion, the dividend-received credit, and the dividend-paid deduction. See *id.* at 552-554; 1978 House Hearings, *supra* note 23, at 3432-63 (statement of Ernest Christian), 6152 (statement of Professor Graetz).

¹⁶⁶ See *supra* notes 33-35 and accompanying text.

¹⁶⁷ 1978 House Hearings, *supra* note 23, at 3419 (statement of Ernest Christian).

¹⁶⁸ See 1986 Passthrough Entity Hearings, *supra* note 8, at 41 (statement of McKee); Sheppard, Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax, 27 Tax Notes 637, 639-40, 647 n.15 (May 6, 1985); Smith, Tax Treatment of Dividends, Compendium, *supra* note 23, at 1543-54.

¹⁶⁹ In 1984, 3,170,743 corporate returns reported a total of \$257,054,060 in taxable income;

lists to be an easy source of revenue.¹⁷⁰ This aspect of corporate taxation was articulated by a witness at Congressman Mills' 1959 tax revisions hearings as "corporations do not vote,"¹⁷¹ and Congressman Byrnes added that this aspect "adds to the ease of collection."¹⁷²

These arguments historically appear to be variants of the pre-1986 double taxation "briarpatch" argument.¹⁷³ Like a rabbit in a briarpatch, a shareholder of both a publicly and closely held corporation had always believed that the double tax "thorns" of the 1954 Code "briarpatch" would never prick him. The inside corporate tax was less than direct taxation and outside realization was usually in the form of long-deferred capital gains, of de minimis present value impact.¹⁷⁴ If this argument is correct, the apparent true aim of the separate entity tax regime appears to have been to afford a tax subsidy to corporate sector income and entrepreneurs for capital formation, while preserving the facade of progressive individual taxation.¹⁷⁵

3,663 returns (each with \$250,000,000 or more in assets) reported a total of \$158,875,836 in taxable income. Dep't of Treasury, Source Book Statistics of Income, Active Corporation Income Tax Returns July 1984 - June 1985 8 (1987).

¹⁷⁰ "Some also contend that given the distribution of ownership of corporate equity, the two-tier tax adds to the progressivity of the income tax system, and that relief from the two-tier tax would disproportionately benefit wealthy taxpayers." Corporate Tax Reform Proposals, *supra* note 33, at 18. See 1978 House Hearings *supra* note 23, at 3504 (statement of Sheldon Cohen), 6119-20 (statement of Hickman). This thought lies at the core of this article's horizontal-schedular equity model. Treasury described the public and political support for a corporate income tax as follows:

Corporations, and large corporations in particular, are widely viewed as separate entities that should contribute, through tax payments, to the cost of government. It is noteworthy as well that prior integration proposals have not received strong support from the corporate sector. Many corporate managers may prefer either reduced income tax rates on all corporate earnings or increased tax preferences for investment over dividend relief or other methods of integration. Some may also be concerned that integration in the form of dividend relief would force larger distributions of corporate income and thus reduce the capital available to corporations for reinvestment. 1986 Passthrough Entity Hearings, *supra* note 8, at 26 (statement of Mentz). Mentz also pointed out the revenue costs of integration. See *id.* at 25-26.

¹⁷¹ 1959 Panel Discussion, *supra* note 23, at 871.

¹⁷² *Id.*

¹⁷³ See *supra* note 34.

¹⁷⁴ See 1978 House Hearings, *supra* note 23, at 6155 (statement of Professor Graetz).

¹⁷⁵ While corporations do not vote, they and their unionized employees often do contribute to political action committees, which may help explain why the rabbits escaped the thorns until 1986. See *supra* note 160. For populist criticism of this situation, see Future Implications of 1986 Act Hearings, *supra* note 49, at 15 (statement of Robert S. McIntyre,

Although not the double tax it purports to be, the actual anticipated large C corporate sector tax of 25% of economic income,¹⁷⁶ plus the tax on owner-level realizations, can be justified as a rough surrogate for the policy ideal of full integration in a truly progressive income tax system.¹⁷⁷ Let us make the unprovable assumption¹⁷⁸ that corporate taxes are borne in the short run by shareholders, albeit possibly in the long run by owners of capital in general.¹⁷⁹ We know that ownership of publicly held C corporations is concentrated in upper income individuals¹⁸⁰ and tax-exempt entities, predominantly qualified retirement plans,¹⁸¹ which also are

Director of Federal Tax Policy, Citizens for Tax Justice); Sheppard, *supra* note 168, at 637, 646. Using a "tax contracts" analysis, see *supra* note 34, it can be argued that corporate management, small businessmen and union members participating in qualified plans would have the most to gain in maintaining the corporate tax status quo and hence could be expected to contribute heavily to members of Congress on the tax writing committees.

¹⁷⁶ Teuber, *Study Finds That Some Profitable Firms Will Escape Taxation Under Reform*, 33 Tax Notes 893 (Dec. 8, 1986).

¹⁷⁷ See 1987 House MLP Hearings, *supra* note 16, at 342, 351-352 (statement of John Lee); Brooks, *A Proposal to Avert the Revenue Loss From "Disincorporation"*, 36 Tax Notes 425, 427-28 (July 27, 1987). Cf. *Corporate Tax Reform Proposals*, *supra* note 33 at 17-18.

¹⁷⁸ See 1986 Passthrough Entity Hearings, *supra* note 8, at 41 (statement of William McKee); *Future Implications of 1986 Act Hearings*, *supra* note 49, at 15, 72 (statement of Robert McIntyre); *Corporate Tax Reform Proposals*, *supra* note 33, at 21; Ballentine, *Where Is the Income Tax Rationale for the Shift to Higher Corporate Rates?*, 30 Tax Notes 443, 445-46 (Feb. 3, 1986); Kies, *supra* note 51, at 184. A survey of the literature and Hearings leads to the conclusion that those in favor of vertical equity assume that the corporate tax is borne by the owners or capital in general long-term. See, e.g., Cohen Symposium, *supra* note 156, at 579; Sunley, *supra* note 23, at 63. (For an exposition of the economic theory that the corporate sector tax in the long run is borne by capital in general—by lowering the return on non-corporate investments—see Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719, 725 (1981)). But a largely Democratic Congress was not willing to count such income taxes as imputed to high income owners for purposes of "distributional acceptability." See 1986 Passthrough Entity Hearings, *supra* note 8, at 41 (statement of William McKee); Feldstein, *supra* note 7, at 37. Conversely, those favoring the status quo argue that the incidence is unknown. See 1986 Passthrough Entity Hearings, *supra* note 8, at 41 (statement of William McKee); Cohen Symposium, *supra* note 156, at 589 (statement of Dr. Charles Walker).

¹⁷⁹ From a populist schedular income point of view, it should make little difference whether the corporate tax is borne by shareholders or capitalists in general. Both groups are not taxed in a sufficiently progressive manner, see Sunley, *supra* note 23, at 63, and are ultimately the same people. See *Concentration of Wealth*, *supra* note 7, at 24.

¹⁸⁰ See *Concentration of Wealth*, *supra* note 7, at 24 (top half of one percent of owners of income own 46.5% of personally held corporate stock; next half of one percent own 13.5% and next nine percent own 29.3%).

¹⁸¹ See *supra* note 7.

largely the owners of capital in general.¹⁸² As a practical matter, such individuals' income from noncorporate sources is not taxed at very progressive effective rates (about 22% of economic income), thus violating vertical equity.¹⁸³ And if the individuals earned the corporate sector income directly, due to the preferences and leverage discussed below,¹⁸⁴ any tax on such income would arise only under the individual minimum tax regime.¹⁸⁵ As to large C corporation stock held by tax-exempt shareholders, e.g., retirement plans, less than half the work force is covered by qualified retirement plans, so that additional tax benefits there too violate horizontal equity.¹⁸⁶ Consequently, separate entity taxation as to large active businesses with inactive owners yields rough justice, if this income is attributed to the owners, by partially offsetting the lack of vertical or horizontal equity in the existing system.¹⁸⁷ In short, the corporate sector tax can be justified as effecting in a "schedular fashion" the horizontal and vertical equity principle that all large active business/passive owner income should be treated equally.¹⁸⁸

As a matter of tax policy, both large limited partnerships and PTPs conducting an active business should be treated as separate entities, and such entities should proportionately carry the corpo-

¹⁸² See *Concentration of Wealth*, supra note 7, at 24; Feldstein, supra note 7.

¹⁸³ See 1987 Senate MLP Hearings, supra note 7, at 227 (statement of Richard Gordon); see supra note 43.

¹⁸⁴ See infra notes 191, 192, 233 and 322 and accompanying text for further discussion of preferences and leveraging.

¹⁸⁵ See infra notes 189-192 and accompanying text.

¹⁸⁶ As of 1983, only 56% of non-agricultural workers were covered by employer-sponsored qualified retirement plans, with more highly paid employees much more likely to be covered (82% of employees earning above \$25,000 were covered). See *Concentration of Wealth*, supra note 7, at 17; Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. Penn. L. Rev. 851, 876 n.87 (1987).

¹⁸⁷ See supra note 177; Kasten & Sammartino, *The Distribution of Federal Taxes 1975 Through 1990*, 38 Tax Notes 77 (Jan. 4, 1988).

¹⁸⁸ Integration is the ideal means for ending any inside shelter, see generally Sheppard, supra note 168, but so long as it is not obtainable, economic efficiency and vertical equity mandate that all large corporate sector income (income of large active businesses with inactive owners) carry the large corporate sector effective rate, plus some load for anticipated effective rate on owner-level realizations. See Cohen Symposium, supra note 156, at 586-87 (statement of Professor Graetz). Schedular income does raise the issue of compartmentalization of income—the Mexican model. See *Future Implications of 1986 Act Hearings*, supra note 49, at 63 (statement of Rep. Archer).

rate sector tax burden.¹⁸⁹ However, OBRA's straight imposition of the current large C corporation double tax regime on PTPs itself violates such horizontal schedular equity. In large C corporations, classic "double taxation" under the *regular* income tax regime is virtually non-existent (as Treasury and others have repeatedly pointed out to Congress¹⁹⁰) due to the cumulative effect of leverage,¹⁹¹ preferences¹⁹² and low rates of earnings distributions, with shareholder realizations arising more frequently through capital transactions such as sales (possibly after basis step-up due to the prior owner's death).¹⁹³ Consequently, the true large C corporation inside tax often is the alternate minimum tax,¹⁹⁴ with an effective

¹⁸⁹ See authorities cited in *supra* note 188.

¹⁹⁰ See 1986 Passthrough Entity Hearings, *supra* note 8, at 22 (statement of Mentz).

Corporations taxed under Subchapter C typically operate in a manner that postpones or avoids double taxation of their income. Thus, double taxation encourages corporations to retain rather than distribute income, so as to defer the second level of tax and give shareholders the opportunity to realize such income through a sale of stock, gain on which is generally taxed at favorable rates. In addition, double taxation encourages corporations to raise new capital through the issuance of debt, interest payments on which are deductible, rather than through the issuance of stock, dividend payments on which are not deductible. Similarly, closely held corporations are encouraged to distribute income to their owners in the form of deductible salary or rental payments. Although current law attempts to restrict avoidance or postponements of the double tax on corporate income (for example, through the collapsible corporation provisions, the personal holding company tax, the accumulated earnings tax, rules characterizing debt as equity, and rules limiting the deduction of unreasonable compensation), the double tax is, in practice, to some extent mitigated.

Id. See also 1987 Senate MLP Hearings, *supra* note 7 at 63 (statement of Mentz), 114 (statement of Lawrence Cohen); 1986 Passthrough Entity Hearings, *supra* note 8, at 67-68 (statement of Professor Ginsburg); 1978 House Hearings, *supra* note 23, at 3517, 3521-24 (statement of Dennis Gaffney); Lewis, A Proposed Treatment for Corporate Distributions and Sales in Liquidation, *Compendium*, *supra* note 23, at 1643.

¹⁹¹ See Acquisitions and Mergers Hearings, *supra* note 27, at 120-25, 130-37, 161-62 (statement of Brockway), 612 (statement of Rep. Flipppo), 762-64 (Professor Eustice), Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., *Federal Income Tax Aspects of Mergers and Acquisitions 4* (Comm. Print 1985) [hereinafter *Mergers & Acquisitions Hearings Pamphlet*]; 1984 Treasury Proposals, *supra* note 9, at 193-194.

¹⁹² See Acquisitions and Mergers Hearings, *supra* note 27, at 191 (statement of Ronald Pearlman); *Mergers & Acquisitions Hearing Pamphlet*, *supra* note 191, at 5; see 1984 Treasury Proposals, *supra* note 9, at 156, 162.

¹⁹³ See Acquisitions and Mergers Hearings, *supra* note 27, at 191-92, 205-06 (statement of Ronald Pearlman); *Corporate Tax Reform Proposals*, *supra* note 33, at 20.

¹⁹⁴ By substantially broadening the laundry list of tax preferences and adding 50% of corporate book income over taxable income as a preference, the Tax Reform Act of 1986 defined a comprehensive income base under the minimum tax regime, for the first time approaching the measurement of economic income. See 1986 Bluebook, *supra* note 51, at 433-34.

rate for large C corporations in general of 25% of economic income.¹⁹⁵ Moreover, estimates of outside shareholder level realizations through dividends range from 7% to 50%.¹⁹⁶ By and large, PTPs with active businesses differ substantially from large C corporations as to at least two of these factors, both of which contribute to the immunity of large C corporations from double taxation: PTPs have lower leverage rates¹⁹⁷ and higher rates of distribution than do large C corporations.¹⁹⁸ These differences result in a sub-

The 1986 Act elevates the minimum tax from a backstop for the regular tax to an integral part of the tax system. The old add-on minimum tax for corporations is replaced with a new alternative tax. The expanded list of tax preferences includes 50 percent of the difference between pre-tax book income and minimum taxable income.

With the advent of the book income preference, the corporate income tax can be viewed as involving three tax systems, with three different depreciation rules and three different tax rates. Specifically, there is a regular tax with ACRS depreciation and a 34 percent tax rate. There is a regular minimum tax with non-incentive depreciation and a 20 percent tax rate. There is a third tax on excess book income with book income depreciation and a 10 percent tax rate.

Sunley, *supra* note 23, at 65.

While no data seems available as to the number of corporations now paying taxes under the alternate minimum tax ("AMT") rather than the regular tax regime, commentators using computer simulations have concluded that the AMT under the 1986 Senate bill (largely followed by the Conference, see 1986 Conference Report, *supra* note 106, at II-263-II-283) has its greatest impact on young, growing, capital intensive corporations. See Lucke, Eisenach & Dildine, *The Senate Alternate Minimum Tax: Does it Snare only the Tax "Abuser"?*, 32 Tax Notes 681 (Aug. 18, 1986); Harter, *How Tax Reform Would Affect Companies with Different Growth and Profitability Characteristics*, 31 Tax Notes 297, 300 (Apr. 21, 1986).

¹⁹⁵ See Teuber, *Study Finds That Some Profitable Firms Will Escape Taxation Under Reform*, 33 Tax Notes 893 (Dec. 8, 1986) (thousand largest corporations had average effective rate of 20.91 percent of economic income in 1985; under 1986 rules the average effective rate would have been 25.6%).

¹⁹⁶ See 1987 Senate MLP Hearings, *supra* note 7, at 76 (Table 1 of Treasury statement assumes that 93% of the retained corporate equity is taxed as a capital gain and 7% as a dividend). Based on Treasury statistics of corporate earnings and dividend income, an amount equal to 50% of current corporate taxable earnings has been annually distributed. See *id.* at 226 (based on 1985 Statistical Abstract of the United States); Lewis, *A Proposal for Corporate Distributions and Sales in Liquidation*, Compendium, *supra* note 23, at 1643. The latter approach fails to account for erosion of the corporate base.

¹⁹⁷ See 1987 Senate MLP Hearings, *supra* note 7, at 79 (appendix to Treasury statement). Industry witnesses stated that low PTP debt-equity ratios reflected a yield orientation of investment. See *id.* at 89-90, 138, 146, 168, 197, 213-14.

¹⁹⁸ See *id.* at 70, 90, 135, 138, 168, 197, 213. Cash flow appears greater than taxable income (13 to 15% vs. 2.4% return on investment). See *id.* at 89, 79. Undoubtedly, this difference reflects heavy use of tax preferences by PTPs, as should be expected in that many of the PTPs are in the natural resource business. See *id.* at 77. Oil and gas PTPs show a 1.4% taxable income return while real estate and timber MLP's show a 5.8% return. See *id.* at 79. From this yield orientation, commentators and Congress concluded that the PTP structure favored mature businesses with a steady cash flow. See *id.* at 36. However, in 1987, Treasury

stantially greater incidence of double taxation and higher effective rates when the tax burdens on the owners and the entity are combined.¹⁹⁹

Thus, true horizontal schedular equity would call for taxation of PTP limited partners and limited partners in other large limited partnerships conducting active businesses at a rate equal to the anticipated large C corporate rate (25% of economic income) plus the anticipated tax on outside large C corporation shareholder realizations of such income. A roughly equivalent and nicely symmetrical rate might be 28% of entity-level net economic income or perhaps of the corporate alternate minimum tax base, which also neatly solves the historical integration problem of preferences.²⁰⁰ Owner withdrawals of this income would not trigger a second tax

argued that a more recent trend was for PTPs to distribute only amounts equal to unit holder-level taxes or entity-level tax savings (PTP and owners as contrasted with C corporation tax). See *id.* at 68-69.

¹⁹⁹ 1987 Senate MLP Hearings, *supra* note 7, at 114 (statement of Lawrence Cohen) (describing tax burden of master limited partnership as equivalent to double taxation of corporations).

²⁰⁰ See 1978 House Hearings, *supra* note 23, at 6145, 6148-49, 6161-63 (statement of Professor Graetz). The Joint Committee Staff raises the following issues as to whether to pass through preferences:

If the purpose for granting relief from the two-tier tax is to eliminate corporate level tax entirely and to treat corporate income as earned directly by shareholders, it could be argued that all preference items of a corporation should be attributed directly to its shareholders, regardless of whether they are individuals or other corporations.

On the other hand, relief from the two-tier tax may be considered simply an effort to eliminate the burden of any existing corporate level tax, at least so long as funds remain in corporate solution. Although most preference items are available both to corporations and individuals, it may be argued the effect of various preferences in the Code is largely to reduce corporate taxes. For example, even though the investment credit and ACRS are available to both corporations and individuals, these provisions benefit corporations in overwhelming proportions. Under this view, it would be inappropriate to permit provisions that reduce corporate income taxes to reduce the income taxes of a corporation's individual shareholders as well. Nevertheless, it may be considered appropriate to assure that the benefit of a preference item is continued so long as the related income remains in corporate solution (even though distributed to a corporate shareholder that has made a portfolio investment and is otherwise unrelated to the distributing corporation).

Corporate Tax Reform Proposals, *supra* note 33, at 27 n.42. Implicitly this distinction underlies the PAL provisions generally inapplicable to corporations. The essence of the 28% alternative minimum tax rate for corporations was apparent to industry lobbyists who opposed the proposed model when presented at the 1987 House master limited partnership hearings. See 1987 House MLP Hearings, *supra* note 16, at 361-62 (statement of Jeffrey Rosenthal of the National Association of Realtors and the Real Estate Securities and Syndication Institute).

under this model, and losses would not pass through. Of course, if this worked for active business PTPs, the model could then be extended to large C corporations with no revenue loss.²⁰¹

2. *Small C Corporations: Inside Tax Shelter*

The integration debate usually has focused on double taxation as a violation of horizontal equity and especially as encouraging debt over equity financing.²⁰² The reality too often under the 1954 Code, occasionally as to large C corporations²⁰³ and usually as to small, and hence close C corporations,²⁰⁴ was that double taxation provided an inside tax shelter. Under such a tax shelter, the owners and the C corporation, in the aggregate, using well-publicized tax planning techniques,²⁰⁵ paid less income taxation than the owner would have paid in direct taxation under full integration. This inside shelter was thought by some to continue under the 1986 Code, at least as to small C corporations.²⁰⁶ The shelter may, however, be subject to substantial transactional tax costs, which create most of the complexity in tax practice as to small businesses.²⁰⁷ Moreover, the second, outside tax on shareholder realiza-

²⁰¹ Id. at 342, 351 (statement of author).

²⁰² See supra notes 23 and 29 and accompanying text.

²⁰³ See authorities cited in supra note 141. The highest marginal individual rate under the original 1954 Code was 91% on taxable income in excess of \$300,000, see Int. Rev. Code of 1954 § 1(a), while the maximum corporate rate was 52%. Id. § 11(b) and (c).

²⁰⁴ See 1978 House Hearings, supra note 23, at 6155 (statement of Professor Graetz).

²⁰⁵ See supra note 130.

²⁰⁶ See Kramer, Take a Hard Look Before Electing S Corporation Status, 1 Tax Times No. 4, p. 14 (Dec. 1986). But see Magette & Rohman, Choice of Business Entity After the Tax Reform Act of 1986: The Brave New World, 12 Rev. of Tax'n of Indivs. 38, 62 (1988); Bogdanski, Using Corporations for Tax Savings—A Reappraisal, 14 J. Corp. Tax'n 160 (1987).

²⁰⁷ For example, balancing income from a business venture between compensation to principal and retained taxable income not exceeding the lowest corporate graduated rate brackets generates the problem of "unreasonable compensation" not deductible by the corporation under § 162 of the Code. Retention of corporate earnings to obtain the lower inside tax rate, rather than payment to shareholders which triggers true double taxation, poses "accumulated earnings tax" problems, see Watkins & Jacobs, Closely Held Businesses: Tax Planning After ERTA, Tax Adviser 516 (1982); Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reform Before the House Comm. on Ways and Means, 98th Cong., 2d Sess. 156 (1984) (statement of Professor Ginsburg). Retention of earnings inside the corporation to carry on a personal investment program causes personal holding company tax problems as well. See Corporate Tax Reform Proposals, supra note 33, at 4. Furthermore, particularly in service organizations, splitting personal service income between the C corporation and the shareholder-employee gives rise to intense problems re-

tions often proved mythical. Only a small portion of corporate earnings was intentionally distributed as dividends²⁰⁸ and shareholder realization of built-in gain or retained earnings was more commonly affected through sales (or perhaps redemptions or liquidations in a close C corporation context).²⁰⁹ Such capital transaction realizations yielded no revenue if carried out by the owner's estate or heirs after a date-of-death income tax-free step up to fair market value.²¹⁰ This sort of use of the corporate entity to produce less tax liability than would be owed in direct taxation of the owner violates sound tax policy, particularly where the owner actively participates.²¹¹ Horizontal equity and economic efficiency are violated because the same source income earned by a sole proprietor or partner would be taxed at a higher rate.²¹² Additionally, since the owners of close C corporations are higher income taxpayers than the owners of C corporation stock in general (themselves a high income class), vertical equity is violated as well.²¹³ Again, the true issue is not whether there is double taxation, but whether there will be even one full tax collected at least once.²¹⁴

PSCs constitute the most glaring abuse of graduated inside rates, since most owners of PSCs actively participate in the business. Indeed, stock ownership is usually restricted to those licensed to practice the profession.²¹⁵ But wherever the owners materially participate, the abuse occurs, whether by corner druggist, grocer,

lating to I.R.C. § 482 deemed arm's-length reallocation of income or deductions. Even where 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 gives rise to new sets of tax problems, e.g., whether withdrawals structured as "loans" constitute constructive dividends, sale/exchange or dividend treatment applies to redemption payments upon retirement, and whether the "collapsible" corporation provisions will apply. The latter two problem areas should disappear, except for basis recovery in redemptions, if the 1988 elimination of the capital gains preference remains in the 1986 Code. Finally, offsetting the use of a close C corporation as an inside tax shelter was one of the primary post-facto justifications for the 1986 repeal of the General Utilities doctrine. See Sheppard, *General Utilities Repeal*, 33 Tax Notes 183 (Oct. 13, 1986).

²⁰⁸ See *supra* note 174.

²⁰⁹ See *supra* note 196 and accompanying text.

²¹⁰ Corporate Tax Reform Proposals, *supra* note 33, at 17-18, 49.

²¹¹ Cf. Preliminary Subchapter C Report, *supra* note 9, at 88.

²¹² See *supra* notes 30-32 and accompanying text.

²¹³ See *supra* notes 30-32.

²¹⁴ See *supra* note 35.

²¹⁵ Eaton & Church, *Professional Corporations and Associations*, 17 Bus. Orgs. (MB) § 9.04[10] (1987).

small manufacturer or builder, as the 1984 Treasury proposals recognized.²¹⁶ Yet OBRA's denial of graduated rates to PSCs alone is too narrow and generates only a fraction of the revenues that would arise from repeal of the graduated corporate rates for small C corporations in general.²¹⁷

C. Passive Activity Loss Provisions

The deep structure policy supporting many of the PAL rules is a corollary of basic classification policy. If an owner does not actively or materially participate in the management or operations of an entity, the entity should be taxed as separate.²¹⁸ Losses of a separate entity should not immediately flow or pass through to its owners; rather, an owner should realize and recognize any decline in value of his interest in a separate entity only upon disposition of such interest or its becoming worthless.²¹⁹ This has long been the case as to shareholders and C corporations,²²⁰ as well as to investors in passive income, separate conduit entities such as REITs and RICs.²²¹

Deep structure analysis demonstrates that aiming the PAL provisions at passive owners of active businesses was too narrow as a matter of policy. And, indeed, Congress gave Treasury in the 1986 Code the authority to bring within the PAL provisions a passive activity that does not rise to "trade or business" status,²²² so long as the activity does not produce "portfolio income."²²³ But the netting among different passive activities contravenes this deep structure policy.

In addition to tax policy reasons, Congress also based the 1986 Code PAL provisions on political considerations. Preservation of

²¹⁶ See 1984 Treasury Proposals, *supra* note 9, at 128-29.

²¹⁷ The denial of graduated rates for personal service corporations is expected to increase revenues by \$75 million in 1988, \$125 million in 1989 and \$140 million in 1990. See 1987 Senate Report, *supra* note 97, at 219. The author estimated at the 1987 House MLP Hearings that the range of revenue in denial of graduated brackets for all close C corporations with profits would be \$1 to \$5 billion a year. See 1987 House MLP Hearings, *supra* note 16, at 34 (statement of author).

²¹⁸ See *supra* notes 142-143 and accompanying text.

²¹⁹ See 1986 Senate Report, *supra* note 7, at 717.

²²⁰ See I.R.C. § 165(g); 1986 Senate Report, *supra* note 7, at 717.

²²¹ See *supra* notes 66 and 67.

²²² I.R.C. § 469(c)(6)(B).

²²³ 1986 Conference Report (vol. II), *supra* note 106, at 138.

the corporate sector tax base was not the goal here, since most passive-type income enterprises traditionally have chosen the partnership form.²²⁴ Congress' focus instead was on curbing expansion of tax shelters.²²⁵ Thus, Congress' most obvious concern was stemming loss of faith in the federal income tax system due to widespread awareness of tax shelter abuses. The public apparently perceived that high-income individuals were using tax shelters to reduce or even eliminate the current incidence of taxation on their portfolio income and salaries.²²⁶ But more importantly,

a provision significantly limiting the use of tax shelter losses [was] unavoidable if substantial rate reductions [were] to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax that [was] borne by high-income taxpayers as a group.²²⁷

This policy would dictate complete separate basket treatment for each PAL activity or at least each entity conducting the activity. Thus, the passthrough PTP separate-basket PAL rule is correct as a matter of policy, but the general PAL netting rule is incorrect, with the end result of horizontal inequity turning solely on the fact of public trading. The political reality which better effected policy considerations in 1987 than in 1986 was that the revenue generated

²²⁴ See 1987 House Report, *supra* note 21, at 1066. See also 1987 House MLP Hearings, *supra* note 16 at 364-65 (statement of Rosenthal).

²²⁵ See 1986 Senate Report, *supra* note 8, at 714.

²²⁶ *Id.* at 713-14.

²²⁷ *Id.* at 714. The Minority Tax Counsel to the House Ways and Means Committee explained, during the gestation of the 1986 Code, that the goal of "distributional acceptability," i.e., that "the direct effect of the individual tax changes [would] . . . not result in a larger percentage tax decrease for higher income taxpayers than for middle- and lower-income taxpayers," mandated reaching five major individual taxpayer-side decisions necessary to offset enough of the top marginal rate reduction benefits to higher-income taxpayers to achieve this result. Kies, *supra* note 51, at 183; see also Ballentine, *The Short-Run Distributional Effect of Tax Reform*, 31 *Tax Notes* 1035, 1037 (June 9, 1986).

Those major changes included (1) the elimination of the preferential capital gains rate, (2) the passive loss rules on a generally retroactive basis, (3) the provisions which phase out the benefits of the 15 percent marginal rate bracket and the standard deduction for higher-income taxpayers, (4) the elimination of individual retirement accounts generally for taxpayers with over \$50,000 of income, and (5) limits on the deductibility of investment interest. These decisions, while difficult for the conferees, were essential to achieve a distributionally acceptable package.

Kies, *supra* note 51, at 184 (footnotes omitted).

The legislative history explicitly confirms this trade-off as to passive losses. See 1986 Senate Report, *supra* note 8, at 716-17.

by the PTP changes was provided primarily in the PAL provisions.²²⁸

IV. CONGRESSIONAL RATIONALES FOR OBRA CHANGES AND CRITIQUE

A. PTPs: A Classification Issue

1. Reclassification of Active Business PTPs

Congress based its classification of active business PTPs as C or regular corporations on preservation of the "corporate sector tax base"²²⁹ and two horizontal equity arguments: functional resemblance to corporations;²³⁰ and practical availability only to mature cash flow ventures, as contrasted with start-up or capital intensive ventures, which had created an unlevel playing field²³¹ (i.e., horizontal disparity or "economic inefficiency"²³²).

²²⁸ See 1987 Senate MLP Hearings, *supra* note 7, at 78 (statement of Mentz). Industry witnesses heavily emphasized this fact. *Id.* at 157 n.5. Treasury's response was that it was concerned about future erosion. *Id.* at 47 (testimony of Mentz); *id.* at 179 (statement of Richard Cohen).

The real estate and natural resources lobbies had acquiesced in the idea of PAL portfolio income treatment of PTP income from such sources by the time of the 1987 MLP hearings. See 1987 Senate MLP Hearings, *supra* note 7, at 177, 304. But see *id.* at 219, 272-73.

²²⁹ 1987 House Report, *supra* note 21, at 1065; 1987 Senate MLP Hearings, *supra* note 7, at 72-73 (statement of Mentz).

²³⁰ 1987 House Report, *supra* note 21, at 1066.

Publicly traded partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for the duration of the conduct of its business enterprise.

Id.

²³¹ 1987 House Report, *supra* note 21 at 1066.

²³² The "overriding objective" of the 1984 Treasury proposals as to reform of capital and business income was "to subject real economic income from all sources to the same tax treatment." 1 U.S. Dept. of Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth—Overview xii (1984) [hereinafter Overview of 1984 Treasury Proposals].

Implementation of the reforms proposed by the Treasury Department would cause improved reallocations of economic resources. The lower tax rates made possible by base-broadening and the more realistic rules for the measurement of income and calculation of tax liabilities will increase the attractiveness of industries that suffer under the weight of the current unfair and distortionary tax regime. Both established industries and new "high-tech" industries will benefit from tax reform. But the ultimate beneficiaries will be the American public. No longer will the nation's scarce economic resources—its land, its labor, its capital, and its inventive genius—be allo-

a. Corporate Sector Tax Base

The 1986 Act constituted a marked and important transition

cated by the tax system, instead of by market forces. The result will be more productive investment, greater opportunities for employment, more useful output, and faster economic growth.

Id. See also *id.* at 13.

The Overview then described the erosion of the tax base during the 1954 Code by tax preferences, which required high, progressive rates and which resulted in diminished saving and investment:

The lack of a comprehensive income tax base has two obvious and important adverse effects on the ability of the marketplace to allocate capital and labor to their most productive uses. First, the smaller the tax base, the higher tax rates must be to raise a given amount of revenue. High tax rates discourage saving and investment, stifle work effort, retard invention and innovation, encourage unproductive investment in tax shelters, and needlessly reduce the Nation's standard of living and growth rate.

Second, tax-preferred activities are favored relative to others, and tax law, rather than the market, becomes the primary force in determining how economic resources are used. Over the years, the tax system has come to exert a pervasive influence on the behavior of private decision-makers. The resulting tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production, and reduced consumer satisfaction.

The existing taxation of capital and business income is particularly non-neutral. It favors capital-intensive industries over others, such as services. The tax system favors industries that are unusually dependent on equipment over those—such as wholesale and retail trade—that rely more heavily on other forms of capital, including inventories and structures. High technology companies are put at a particular disadvantage. Since they do not require large capital investments that benefit from preferential tax treatment they bear the full brunt of high tax rates. A tax system that interferes less with market forces in the determination of what business should produce—and how—would be more conducive to productive investment and economic growth.

Id. at 4-5.

The 1984 Treasury Proposals consistently applied the ideal of economic efficiency in analyzing 1954 Code tax preferences. For example, the proposals argued that a host of taxpayer favorites hindered economic efficiency: tax-free fringe benefits and deductible business travel and entertainment expenses encourage consumption, 1984 Treasury Proposals, *supra* note 9, at 21, 23, 29, 33, 36, 82 and 87-88; double taxation of C corporations and deductibility of interest encourage financing by retained earnings and debt and increase the cost of capital, *id.* at 135; low or negative effective tax rates from 1954 Code capital recovery (ACRS and ITC) schemes distort investment decisions in a variety of ways, *id.* at 156, 173-74; the capital gains tax preference distorts investment decisions by providing a potentially lower effective tax rate on asset appreciation (including retained corporate earnings) than on current earnings from dividends or interest, *id.* at 180; failure of tax accounting and tax treatment of indebtedness rules to accurately account for inflation produces a host of economic inefficiencies, see *id.* at 190, 193-94; lack of uniform capitalization rules encourages self-construction and gives own-use producers and tax shelters with multi-period costs a competitive advantage, *id.* at 205-06, 210; various rules give financial institutions low rates, *id.* at 219, 253, 256 and 259; and rapid amortization results in distortions. *Id.* at 227, 241 and 305-09.

For a critical view of the supposed increase in economic efficiency of the 1986 Code as

from the traditional 1954 Code tax reform process to the less tax preference- and leverage-driven 1986 Code tax reform process, at least for the near term. Tax reform in the 1970s and the first half of the 1980s consisted primarily of disbursing unlegislated revenue increases, which resulted from inflation-driven bracket creep, in the form of individual tax cuts and increased availability of tax preferences.²³³ The 1986 Act retained the traditional individual tax cut feature (without any substantial increase in tax expenditures), but was funded by a seemingly equivalent increase in the large C corporate sector tax burden.²³⁴ Thus, according to Assistant Secretary Mentz, the goal of preserving the corporate tax base rested on the 1986 Act's attempt to balance individual rate reduction by an equal and "substantial increase in revenues from the corporate sector."²³⁵ In reality, the erosion of the corporate sector tax base, which accelerated during the decade prior to the 1986 Act, would not have occurred through post-1986 "disincorporation" of large C corporations.²³⁶ Instead such erosion would have occurred over the

finally enacted, see *Future Implications of the 1986 Act Hearings*, *supra* note 49, at 98-99 (statement of Jerry Jasinowski).

²³³ See Leonard, *supra* note 47, at 971 (tax expenditures rose from 50% of total income tax revenues in 1974 to over 100% in 1986); Verdier, *The Prospects for Tax Stability*, 35 *Tax Notes* 171, 172 (April 13, 1987).

²³⁴ The individual side estimated tax cuts total \$122 billion dollars over the 5 year window period (1986-90) while the corporate side increase over the same period is estimated to be \$120 billion. Sunley, *supra* note 23, at 63. However, a substantial part of the corporate side changes are accounting period changes accelerating income from the out years (beyond 1990), and hence could be said to reduce corporate side taxable income then. See Kiefer, *The Progressivity Effects of the Finance Committee Tax Reform Bill*, 31 *Tax Notes* 1031, 1034 (June 9, 1986).

Moreover, the large C corporations undoubtedly have the greatest access to tax planning. Already, preliminary data indicate that for the federal fiscal year ending September 30, 1987, the corporate sector tax receipts were \$21 billion below projections (\$84 billion vs. \$105 billion). See *Business as Usual: Under New Tax Law, Corporations Still Find Ways to Reduce Rates*, *Wall Street J.*, June 2, 1988, at 1, col. 6 and at 12, col. 1. While a slow economy contributed to the short-fall, the blunting of the minimum tax also appeared to have played a significant role. *Id.* at 1, col. 6.

²³⁵ 1987 Senate MLP Hearings, *supra* note 7, at 73 (statement of Mentz).

²³⁶ Congress did mention "disincorporation," i.e., conversion of a large C corporation into a publicly traded partnership and, hence, elective integration of the corporate and shareholder levels of tax circumventing the congressional intent to preserve the corporate level tax. See 1987 House Report, *supra* note 21, at 1066. But Treasury and other witnesses agreed that the IBMs and General Motors's of the world would not shift to the PTP form. See 1986 Passthrough Entity Hearings, *supra* note 8, at 39 (statement of Mentz); 50-51 (statement of McKee & Kuller); 72 (statement of Professor Ginsburg). Under the 1986 Code, the immediate cost of full inside recognition of built-in gain to the liquidating corpo-

long run through the structuring of new ventures as limited partnerships, with a view to going public later as PTPs,²³⁷ and the shifting of future appreciation in existing C corporation assets to limited partners in PTPs, utilizing the "frozen" general partnership interest technique.²³⁸

Ironically, the 1986 Act made a number of changes which, Treasury and Congress believed, made

conduit entities more attractive as vehicles for business activity than corporations. For example, under the 1986 Act, the maximum regular corporate tax rate is higher than the maximum individual tax rate. Thus, in addition to the fact that corporate earnings bear a second level of tax when distributed, retained earnings are generally taxed at a higher rate than amounts directly earned by an individual. In addition, by increasing the tax rate on capital gains and making that rate generally equivalent to the rate on ordinary income, the Act reduced an investor's incentive to realize income through sales of appreciated stock rather than in the form of current income.

Further, the 1986 Act generally imposed a corporate level tax on certain liquidating sales and distributions that were not taxed under prior law. Appreciation in corporate assets is thus now subject to a corporate level tax on the ultimate disposition of the business. The 1986 Act also included a new corporate minimum tax regime that includes as a preference item a portion of the excess of

ration under § 336, plus outside owner-level recognition under §§ 331 and 1001 of appreciation, less the inside tax, outweighed the present value of a step-up of depreciable assets to fair market value in the PTP's hands. Even under the 1954 Code, the current tax costs of the "recapture income" overrides to the *General Utilities* shield against recognition of built-in gain upon liquidation, a sale pursuant to liquidation, or a deemed sale pursuant to a deemed liquidation (Int. Rev. Code of 1954 §§ 336, 337 and a later version of 338, respectively), often outweighed the present value of the step-up. See Cohen Symposium, *supra* note 156, at 700 (comments of Sam Thompson); cf. Sheppard, *Mirror Moves: Life Without the General Utilities Rule*, 32 Tax Notes 847 (Sept. 1, 1986).

²³⁷ "The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base." 1987 House Report, *supra* note 21, at 1065; see also 1987 Senate MLP Hearings, *supra* note 7, at 55 (statement of Mentz) (new ventures would find their way into MLP form), 141 (statement of John Chapoton) (existing corporate tax base protected from erosion by repeal of *General Utilities*).

²³⁸ See Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities*, 64 Taxes 962, 967-90 (1986).

the income that is reported for financial purposes over the amount of corporate alternative minimum taxable income.²³⁹

Indeed, in the 1986 passthrough entity hearings, Assistant Secretary Mentz stated that if he were in private practice advising a client starting a business, "I would advise him to start in limited partnership form, because that way you get to the one level of taxation right away."²⁴⁰

The above-mentioned factors of a maximum inside corporate income tax rate higher than the outside maximum individual rate (often actually a "phantom" rate of 33% rather than 28% would apply at the individual level),²⁴¹ and a corporate level tax on liquidating and non-liquidating sales and distributions of appreciated assets and deemed sales of such assets upon a deemed liquidation, probably are not very significant in reality as to most large C corporations (other than non-leveraged and non-capital intensive enterprises in the case of the rate differentials).

First, as to rate differentials, due to leverage and capital recovery deductions, most large C corporations are *not* taxed under the regular corporate income tax regime.²⁴² Indeed, at the same time the 1986 Act reduced the maximum corporate rate 26% (from 46% to 34%), it actually increased the projected corporate sector tax burden by a net 22% through alternate minimum tax and tax accounting changes (from 21% to 25% of economic income).²⁴³ Thus, the more valid comparison is between the corporate and individual minimum tax regimes,²⁴⁴ and the major "tax preference" item dif-

²³⁹ 1987 House Report, *supra* note 21, at 1065-66. The 100th Congress drew from these changes and the repeal of *General Utilities* "an intent to preserve the corporate level tax," *id.* at 1066. Cf. 1987 Senate MLP Hearings, *supra* note 7, at 31-32, 59-64 (hearing pamphlet and statement of Mentz, respectively).

²⁴⁰ 1986 Passthrough Entity Hearings, *supra* note 8, at 39 (statement of Mentz). Cf. 1987 Senate MLP Hearings, *supra* note 7, at 55-56 (statement of Mentz), 164 and 197-98 (statement and testimony of Barry Miller).

²⁴¹ The humpback 5% rate begins at \$71,900 of taxable income for a married taxpayer filing a joint return. I.R.C. § 11(g). This asymmetric technique was necessary to maintain the fiction of the 28% "maximum" rate and meet the "distributional equitability" requirement that the maximum rate reduction benefit be offset. See Kies, *supra* note 51, at 184; Birnbaum & Murray, *supra* note 23, at 220.

²⁴² See *supra* note 194.

²⁴³ See *supra* note 176 and accompanying text.

²⁴⁴ The 1986 Senate Report, *supra* note 7, at 521-40, analyzes the corporate and individual minimum tax regimes, describing some common tax preferences for individuals and corporations, principally BURB for the latter. These preferences are added back to taxable

ference between the two regimes—50% of the excess of book over taxable income or BURP²⁴⁵—may be more cosmetic than real.²⁴⁶

As to the new “liquidating sales” corporate level tax (i.e., the 1986 Code repeal of the *General Utilities* doctrine)²⁴⁷ referred to by the House Budget Committee report on OBRA,²⁴⁸ today most acquisitions of large C target corporations are not cast as asset acquisitions from a liquidating target.²⁴⁹ Instead, in a tender offer, the acquisition is cast as a stock purchase for control of the target corporation,²⁵⁰ after which the acquiring corporation rarely elected the section 338 step-up before the advent of the 1986 Code and rarely has elected it since.²⁵¹ (Section 338 now triggers the target

income, adjusted by certain items, and then the alternate minimum rate, 20% for corporations and 21% for individuals, is applied. *Id.* at 521-22.

²⁴⁵ I.R.C. § 56(f)(1); see generally Leder, Giving Rise to BURP's (and Other Preferences) Under the New Corporate Minimum Tax: Selected Aspects, 40 *Tax Law.* 557 (1987).

²⁴⁶ The Committee reports do not break out revenue estimates for BURP from the estimates for revenue increases in general from the corporate minimum tax changes.

²⁴⁷ The *General Utilities* doctrine shielded inside appreciation, except for “recapture income” upon a liquidation, liquidating sale, or deemed sale pursuant to a deemed liquidation. See Corporate Tax Reform Proposals, *supra* note 33, at 33-43. The Tax Reform Act of 1986 repealed this exemption. Pub. L. 99-514, 100 Stat. 2085, § 63(a), (b) and (d). See generally Yin, Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986, 42 *Tax L. Rev.* 573 (1987).

²⁴⁸ 1987 House Report, *supra* note 21, at 1065.

²⁴⁹ Acquisitions of closely held targets often are accomplished as asset acquisitions. According to the author's conversations with tax professionals, the difference probably lies in the virtual impossibility of carrying out a tender offer for assets in the large C corporation context.

²⁵⁰ Double taxation and its avoidance through interest deductions is the principal tax factor encouraging purchases. See Acquisitions and Mergers Hearings, *supra* note 27, at 120-21, 134-35, 161-62 (testimony and statement of David Brockway); 191-93 (testimony of Ronald Pearlman); 612 (testimony of Preston Martin, Vice-Chairman, Board of Governors of Federal Reserve System).

²⁵¹ Treasury and the Joint Committee on Taxation Staff believe that the 1954 Code encouraged leveraged acquisitions of lower-leveraged C corporations, especially those with low base, high current value depreciable assets, due to the 1954 Code feature of deductibility of interest but not dividends. (Note that the same is true of the 1986 Code.) See pages cited in Acquisitions and Mergers Hearings, *supra* note 250. See also Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., *Federal Income Tax Aspects of Mergers and Acquisitions* 4-5 (Comm. Print 1985). While they do not discuss whether such acquisitions are cast as cost or carry-over basis acquisitions, witnesses at other hearings and other commentary suggest that purchasers rarely elected cost basis treatment under the 1954 Code. This was evidently the case because “recapture income,” taxable to the target under the 1954 Code upon a liquidation, or sale pursuant to a liquidation triggered upon a stock acquisition and § 338 election, often equalled the present value of any step up in basis of the depreciable asset. See Reform of Corporate Taxation Hearings, *supra* note 9, at 518-21 (statement of David Glickman); Philadelphia Tax Conference Focuses on Business Planning After the 1986 Act, 35 *Tax*

corporate level tax on all appreciation²⁵².) Thus, the target's assets generally retain their old, presumably lower than fair market value basis after acquisition. Theoretically, the acquiring corporation would reduce its purchase price to reflect the loss of step-up in basis,²⁵³ but the practical reality is that the target's purchase price often is based on a multiple of its earnings;²⁵⁴ and earnings are

Notes 934, 935 (June 8, 1987).

Conventional wisdom had it that the purchaser and seller could carve out of the purchase price any costs attributable to such "customer base intangible" assets as goodwill, 1987 House Report, *supra* note 21, at 1058-59, amortizable by the purchaser and purportedly not triggering "recapture income" to the seller. Query whether application of the tax benefit doctrine to recovery of the seller's costs of creating such intangible assets, at one time currently deductible as advertising or other ongoing business expenses, *id.* at 1059, and based on a premise now known to be inaccurate, *viz.*, that such intangibles should give rise to a current deduction, would not produce distortion of income. See Lee & Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. Corp. L. 137, 204-09 (1987). This shield was repealed in 1986. See authorities cited in note 247 *supra*. Now the target will recognize all built-in gain upon a liquidation, asset sale pursuant to a liquidation, or § 338 election. See Yin, *supra* note 247. (Of course, where the target's NOLs equalled the built-in gain or recapture income, election might be advisable.) Nevertheless, Treasury's interest in purchase price allocations and amortization of customer base intangibles once attracted is not easily abated. See I.R.C. § 1060 and H.R. 3545, 100th Cong., 1st Sess. § 10120 (1987) (included among revenue provisions of OBRA, as passed by the House Ways & Means Committee).

²⁵² See generally Yin, *supra* note 247.

²⁵³ Where the stock is sold rather than redeemed the effect of a "double tax" would occur only where the purchaser's price was discounted for the burden of corporate taxation on future earnings.

²⁵⁴ There have been four merger waves since the late 1890s: 1890-1904, 1919-1929, 1960-1969, and 1974 to present. See *Corporate Takeover Hearings*, *supra* note 7, at 147-48 (colloquy between Sen. Riegle and Martin Lipton; Mr. Lipton characterized the present period as a "liquidation wave"). Prior to the mid-1960s, businesses typically combined by merger, sale of assets, consolidation, or through proxy contests. *Id.* at 452 (statement of John Shad, Chairman of the Securities and Exchange Commission [the "SEC"]). In the current wave of mergers, the form of acquisition has shifted to the tender offer, typically using borrowed cash, which results in leveraged takeovers, *id.* at 285, 310 (SEC staff report). See also *id.* at 451 (statement of Shad); 733-36, 742-46 (statement of Preston Martin). The shift has been from the conglomerate merger era of the 1960's to the large, often hostile takeover bids of the 1980's. *Id.* at 668-69 (statement of Felix Rohatyn). While merger transactions in recent years are fewer than in the 1960s, the dollar size of the recent transactions is far larger. *Id.* at 576, 581, 591-93 (statement of Preston Martin). These tender offers average a 30% to 50% premium above current trading value of the target shares (which reflect a multiple of earnings). *Id.* at 240 (statement of John Shad). See also Jensen, *Takeovers: Folklore and Science*, 62 Harv. Bus. Rev. 109, 112 (1984). This premium may reflect the shelter of the purchaser's interest deductions (for the borrowed purchase price) against the target's earnings or a greater value for the sale of much of target's assets than the stock price. See *Corporate Takeover Hearings*, *supra* note 7, at 45, 137, 157, 596, 672, 751-52, 884, 1101-03. For a case history see *id.* at 1102-03 (statement of Sir James Goldsmith).

actually increased by any lower basis due to lessened capital recovery deductions. In short, the only real factors weighing towards the choice of a passthrough entity for conducting a large active business in the traditional pattern are the higher corporate than individual tax rate in service industries, different corporate and individual alternate minimum tax rules in capital-intensive businesses, and "double tax" on owner level realization of gain in capital transactions (or, more rarely, dividend distributions in high profit distribution ventures).

As discussed previously,²⁵⁵ PTPs often do not fit the traditional large C corporation pattern. Instead, the limited partners' equity traditionally served as an alternative to conventional debt financing, with resultant lower PTP debt-equity ratios and higher rates of PTP distributions (corresponding to debt amortization in conventional large C corporations) than those of large C corporations in general.²⁵⁶ Treatment of active business PTPs as corporations undoubtedly will lead to substitution of conventional financing to buy up the limited partners' interests.²⁵⁷

b. Functional Corporate Resemblance

Congress took a broad approach to functional corporate resemblance, echoing the recent Treasury²⁵⁸ and Joint Committee staff studies:²⁵⁹

Publicly traded partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for the duration of the conduct of its business enterprise.²⁶⁰

However, all of these factors merely embody aspects of the deep

²⁵⁵ See notes 111-143 and accompanying text.

²⁵⁶ See *supra* notes 197 and 198 and accompanying text.

²⁵⁷ 1987 Senate MLP Hearings, *supra* note 7, at 185-95 (statement of Ballentine); 1987 House MLP Hearings, *supra* note 16, at 338 (statement of Wilson).

²⁵⁸ 1987 Senate MLP Hearings, *supra* note 7, at 70-71 (Treasury statement); 1986 Passthrough Entity Hearings, *supra* note 8, at 30-31 (statement of Mentz).

²⁵⁹ 1987 Senate MLP Hearings, *supra* note 7, at 30 (hearing pamphlet).

²⁶⁰ 1987 House Report, *supra* note 21, at 1066; see also 1987 Senate MLP Hearings, *supra* note 7, at 137.

structure issue: whether the owners of the entity have control over the process of earning the entity's income or control the use and disposition of such earnings.²⁶¹ The Joint Committee staff in the 1986 passthrough entities hearing pamphlet described the relationship between these factors and the deep structure issue well:

Certain factors identified as relevant by applicable case law or regulations have a direct bearing on whether an entity is acting separately from its owners, or as their agent or alter ego. For example, each of the four factors relied upon by Treasury regulations to determine whether an entity is taxed as a corporation or as a partnership is relevant to this issue.

The existence of either continuity of life or free transferability of interests suggest that an entity has legal significance substantially separate from the interest of a particular owner. For example, when an entity has these two characteristics, amounts earned while one is an owner may never be distributed to such owner, and amounts distributed to an owner may not have been earned during his period of ownership. Thus, if these two characteristics are present, it can be argued that taxing the entity is appropriate. More generally, such continuity and transferability suggest that the entity is not wholly dependent for its existence on the continuing involvement of current owners, and may continue to exist even if any of such owners cease to possess ownership interests.

The existence of centralization of management suggests that owners of an entity may not, at least by reason of their ownership interests, guide the activities of the entity on a regular and continuous basis. The presence of centralized management suggests at least some separation between the activities of the entity and those of owners, even though the management may be viewed, in some respects, as the agent of owners. In particular, it can be argued that an owner who is not involved in managing the entity is not properly viewed, in a realistic and substantial economic sense, as the party responsible for earning the income of the entity.

For several reasons, the fact that owners have only limited liability with respect to an entity suggests that the entity should be treated as a separate taxpayer. To begin with, limited liability establishes a potentially substantial economic distinction between owners and the entity itself. Limited liability may lessen the degree to which the economic resources of the owners themselves, rather than solely those of the entity, are critical to the conduct of

²⁶¹ See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 14.

the business. In addition, when the liability of owners is limited, the owners may never have to bear losses incurred by the entity in excess of the entity's capital resources. Accordingly, in such a circumstance, it may be inappropriate to view losses of the entity as realized by owners.²⁶²

Although Congress concluded that public trading involved a lack of identity of the owner with the entity, which particularly justified separate taxation of the entity,²⁶³ Treasury itself admitted in the 1986 passthrough entity hearings that public trading may be "indicative of the existence of the other, more relevant, classification factors . . . that may, to a lesser extent, be present in many other partnerships."²⁶⁴ Assistant Secretary Mentz apparently based selection of public trading as the sole criterion for corporate treatment of limited partnerships upon political considerations, such as the repeated lack of success of earlier and broader reclassification proposals.²⁶⁵ However, Treasury's reading of political history in this instance myopically overlooked the fact that the earlier, unsuccessful attempts had been aimed at problems (first retirement plans for self-employed persons and then tax shelters) now resolved by Congress,²⁶⁶ so that the political pressure against re-classification may have lessened.²⁶⁷ Had Treasury and then Congress distinguished the question of separate entity treatment from integration/separate taxpayer treatment,²⁶⁸ the goals of deep structure policy might have been attained. Instead, Congress sacrificed good policy and allowed political considerations to carry the day.²⁶⁹ Congress should have coupled separate entity treatment with a horizontally equitable, schedularly equivalent tax rate, which would have served a broader and more equitable policy than

²⁶² *Id.* at 14-15.

²⁶³ See 1987 House Report, *supra* note 21, at 1067.

²⁶⁴ 1986 Passthrough Entity Hearings, *supra* note 8, at 31 (statement of Mentz).

²⁶⁵ *Id.* at 11 (testimony of Mentz).

²⁶⁶ In 1982 Congress provided parity for self-employed persons and qualified corporate retirement plans. See Pub. L. No. 97-248, §§ 235-54, 96 Stat. 324, 505-33 (1982). And in 1986 Congress finally began to stanch the tax shelter hemorrhage through newly enacted PAL provisions. See I.R.C. § 469.

²⁶⁷ See 1986 Passthrough Entity Hearings, *supra* note 8, at 38 (statement of Mentz); 55-56 (statement of Joel Rabinovitz).

²⁶⁸ See *supra* note 146.

²⁶⁹ See *supra* note 265 and accompanying text.

is presently the case.²⁷⁰

c. *Economic Efficiency*

The PTP legislative history underscores one of the great contributions of Reagan era tax reform: articulation of deep structure policy principles, such as economic efficiency (i.e., "economic neutrality"²⁷¹ or horizontal equity). During the Reagan era, serious consideration of tax policy issues evolved from being solely an academic and ideological concern to being a broad-based congressional concern, arguably for the first time.²⁷² The pre-1987 PTP format favored less leveraged, mature enterprises with earnings available for high rates of distributions over start-up and capital intensive (leveraged) enterprises, thus creating "new economic inefficiencies of the type the 1986 Act was designed to reduce."²⁷³ The 1987 changes eliminated some of these inefficiencies through the reclassification of PTPs as regular corporations; but by limiting corporate separate entity treatment to publicly-traded, active businesses conducted in partnership form, Congress left in place the horizontal disparity between large but not publicly-traded corporations and large but not publicly-traded limited partnerships.

²⁷⁰ See supra note 200, accompanying text and preceding sentence in text.

²⁷¹ See supra note 232. Horizontal equity is defined as equal treatment of taxpayers with equal income. Economic efficiency in turn is the principle that a market economy operates most efficiently if all business activities are subject to the same rate of tax, see, e.g., 1986 Passthrough Entity Hearings, supra note 8, at 10 (statement of Mentz); 1984 Treasury Proposals, supra note 9, at 442; Simmons, *The Tax Reform Act of 1986: An Overview*, 1987 B.Y.U. L. Rev. 151, 153. As Representative Downey of the House Ways & Means Committee stated, "[O]ne of the things I learned when I came on this Committee is the desire on our part, especially when you deal with economic matters, to be economically neutral." Tax Shelter Hearings, supra note 102, at 31. See also id. at 26-27. This emphasis is a turnaround from earlier Congressional reliance upon ability to pay coupled with economic incentives. See Simmons, supra at 151, 167-71. This shift has been explained in an ideological sense by Professor Ott. See Ott, supra note 50, at 1223 (sees more balance than Simmons); see also Hettich & Winer, *Blue Prints and Pathways: The Shifting Foundations of Tax Reform*, 38 Nat'l Tax J. 423 (1985). For a brief but cogent statement of the view that the federal tax code should be "neutral," see Corporation Takeover Hearings, supra note 7, at 449 (statement of Shad).

²⁷² See Proceedings of Symposium on the Tax Reform Act of 1986, 31 Vill. L. Rev. 1787, 1791-92 (1986) [hereinafter Symposium on 1986 Act] (statement of Brockway); cf. Minarik, supra note 23, at 1360.

²⁷³ 1987 House Report, supra note 21, at 1066; cf. 1987 Senate MLP Hearings, supra note 7, at 49, 141-42.

2. *Passthrough (Passive Income) PTPs*

Congress based its exception to corporate treatment for "passive income" or passthrough PTPs on two rationales. The first was that investors could choose to acquire, directly and independently, investments generating passive income, such as interest and dividends, from activities not conducted in corporate form.²⁷⁴ The second rationale was based on political considerations and applied to the exceptions for real estate and natural resource development activities. In the case of these activities, political considerations prevailed. Although it acknowledged that a higher level of entity activity might be present in the areas of real estate and natural resource development, Congress reasoned that such activities "have commonly or typically been conducted in partnership form, and . . . disruption of present practices in such activities is currently inadvisable due to general economic conditions in these industries."²⁷⁵

Traditionally, Congress has permitted limited integration as to entity income (but not losses) between a separate entity and its numerous passive owners where the conduit entity conducted only limited business activities in the form of, e.g., REITs and RICs.²⁷⁶ The rationale given for such integration generally has been to enable middle income taxpayers, who are of course numerous, to acquire liquid and diversified passive investments without incurring double income taxation.²⁷⁷ However, the level of permissible activity as to rental real estate and natural resources has been substantially lower than that allowed for passthrough PTPs,²⁷⁸ suggesting that political, rather than policy, considerations dominated Congress' consideration of the treatment of such activities.²⁷⁹

²⁷⁴ 1987 House Report, *supra* note 21, at 1066.

²⁷⁵ *Id.* at 1066.

²⁷⁶ See *supra* notes 66 and 67.

²⁷⁷ See 1959 Panel Discussion, *supra* note 23, at 899-90 (statement of Edwin S. Cohen).

²⁷⁸ See *supra* note 78.

²⁷⁹ Treasury suggested consideration of continued passthrough treatment, ideally more a limited income integration, along the RIC-REIT model for real property rental and natural resource development activities, see 1986 Passthrough Entity Hearings, *supra* note 8, at 31, because activities of holding relatively passive assets and distributing the income to owners *traditionally* were conducted in non-corporate form and a "similar rationale has supported passthrough treatment for publicly traded entities organized as REITs, RICs, and, more recently, REMICs." 1987 Senate MLP Hearing, *supra* note 7, at 73 (Treasury statement). Treasury's numbers show that roughly a third (42) of the 126 PTPs in existence on June 29,

More significantly, passive-owner entities which conduct passive activities generally have been treated as separate entities as to *all* aspects, other than limited integration of income.²⁸⁰ Along these lines, Treasury advocated in 1986²⁸¹ (although not in 1987)²⁸² that instead of the (aggregate) partnership model, Congress should employ a dividend relief provision, comparable to the RIC and REIT approach, such that natural resources development, housing development, and other research and development activities conducted in PTP form be excepted from regular PTP double taxation. Instead, Congress structured OBRA so that it inappropriately permitted continued aggregate treatment (except as to passthrough of some losses under the separate-basket PAL rules) for "passive" activity passthrough PTPs.²⁸³ This congressional structuring could only be due to a failure to separate the entity classification and owner-entity integration policy issues. Nevertheless, this aggregate treatment is consistent with the final 1986 Code REMIC provision, which passes through both income and losses.²⁸⁴

3. *PALs and PTPs*

a. *Active Business PTPs*

In characterizing active business PTPs as corporations for tax

1987 carried on business in natural resources, *id.* at 77; and thus were presumably eligible for continued passthrough treatment. The author recalls that one of the members of the Select Revenue Measures Subcommittee of the House Ways and Means Committee in the 1987 MLP Hearings suggested that politics was the basis for such a passive-type income and traditional partnership activity carve out. See also *id.* at 48, 55. Then Assistant Secretary Pearlman had earlier suggested, *sotto voce*, the possibility of special classification treatment for such traditional partnership activities. See *infra* note 281.

²⁸⁰ See *supra* notes 66 and 67.

²⁸¹ 1986 Passthrough Entity Hearings, *supra* note 8, at 31 (statement of Mentz). Assistant Secretary Pearlman too had been earlier concerned about the impact of reclassification upon capital formation "for natural resource exploration, research and experimentation and housing development." Reform of Corporate Taxation Hearings, *supra* note 9, at 63.

²⁸² 1987 Senate MLP Hearings, *supra* note 7, at 73 (Treasury statement). Perhaps Assistant Secretary Mentz divined some political message in the Conference Committee's failure to follow traditional separate entity policy, as the Senate provisions had, in the REMIC provisions which it adopted in the Tax Reform Act of 1986. See *supra* note 147. Cf. 1987 Senate MLP Hearings, *supra* note 7, at 199 (statement of John Chapoton) (unknown provenance of REIT rules).

²⁸³ See *supra* note 138 and accompanying text. See also sentence following text accompanying note 145, *supra*.

²⁸⁴ See *supra* note 147. Of course, REMICs also contravene the pattern and deep structure policy with their aggregate-like treatment of losses.

purposes, Congress treated PTP income (presumably only to the extent distributed) as portfolio income for purposes of the passive loss rule,²⁸⁵ consistent with the deep structure policy underlying the PTP and PAL provisions.²⁸⁶ An entity should be treated as a separate entity,²⁸⁷ and its distributed income treated as portfolio income, if the owners do not materially participate in its operations or management. Additionally, economic losses tied to an interest in such a separate entity should not be realized by an owner until he disposes of the interest.²⁸⁸

b. Passthrough PTPs

The House of Representatives gave both policy and political rationales in designating special PAL provisions for passthrough PTPs, such as passive-income PTPs. The policy rationale was that such PTPs functionally resemble corporations. The political rationale was the House's desire to reduce the availability of tax shelters. Neither purpose holds up under examination.

Regarding the policy rationale, the House reasoned that passthrough PTPs resemble C corporations in their marketing methods and their accessing of capital markets (on the basis of hoped-for positive current yield on investment).²⁸⁹ The return on investment of such a PTP

is essentially comparable to the return on an investment in corporate stock. Under the passive loss rule, passive losses cannot be applied to offset dividend income. Similarly, the passive loss rule treats as portfolio income [return] from other investments such as interest-bearing obligations. The committee believes that income from all publicly traded partnerships should be treated similarly to income from investments in corporations for purposes of the passive loss rule.²⁹⁰

This rationale for applying the PAL rules to PTPs conflicts with the rationale given for the passive income exception to corporate treatment. The passive income exception is based on the idea that

²⁸⁵ 1987 House Report, *supra* note 21, at 1071.

²⁸⁶ See *supra* notes 139 and 218-219 and accompanying text.

²⁸⁷ See *supra* note 218.

²⁸⁸ See *supra* note 219 and accompanying text.

²⁸⁹ 1987 House Report, *supra* note 21, at 1073.

²⁹⁰ *Id.*

the taxpayer could otherwise directly acquire these investments (which, if held by a PTP, would generate portfolio income²⁹¹) without falling under the passive activity classification. This would be true because the PTP would not be conducting a trade or business²⁹² or be engaged in a section 212 activity rising above the portfolio investment threshold, and yet the PTP's activity would not rise to the level of a trade or business.²⁹³ Similarly, the stated political rationale of retarding expansion of tax shelters²⁹⁴ cuts too broadly in that it would not support any exceptions to the tax shelter rules. Nevertheless, the basic "separate basket" concept of the PAL rules as applied to passthrough PTPs²⁹⁵ is sound as a matter of tax policy. Under the separate basket rule, net income from a passthrough PTP is treated as "portfolio income" and not as "passive income" for purposes of the passive loss rule;²⁹⁶ thus, such income may not be offset by passive losses from a passive activity.²⁹⁷ Also, net losses from a passthrough PTP cannot offset the partner's positive income, whether portfolio income, compensation or passive activity gain; but are instead suspended, offsetting future income from that PTP or being realized upon a complete disposition of the taxpayer's interest in the passthrough PTP.²⁹⁸ This separate basket treatment is consistent with treatment for PAL purposes of the passthrough PTP as a separate entity, due to the owners not materially participating.

Such complete separate basket treatment of passthrough PTPs is much more restrictive than the general passive activities netting rule, which states that losses from one passive activity currently offset income from another passive activity.²⁹⁹ The separate entity analysis presented above shows that such a netting rule is concep-

²⁹¹ *Id.* at 1066.

²⁹² I.R.C. § 469(c)(1)(A).

²⁹³ I.R.C. § 469(c)(6)(B).

²⁹⁴ See 1987 House Report, *supra* note 21, at 1073.

²⁹⁵ See I.R.C. § 469(k)(1); 1987 House Report, *supra* note 21, at 1073; see also *supra* notes 89-93 and accompanying text.

²⁹⁶ See 1987 House Report, *supra* note 21, at 1073; see *supra* note 92 and accompanying text.

²⁹⁷ See generally I.R.C. § 469; 1987 House Report, *supra* note 21, at 1073; 1986 Senate Report, *supra* note 7, at 716, 718-19.

²⁹⁸ See 1987 House Report, *supra* note 21, at 1073.

²⁹⁹ See I.R.C. § 469(d)(1); 1986 Senate Report, *supra* note 8, at 722 ("Losses arising from a passive activity generally are deductible only against income from that or another passive activity.").

tually unsound, due either to overemphasis on schedular income concepts³⁰⁰ or, more likely, political considerations. Unfortunately, the end result either way is schedular horizontal inequity. Similar passive activities (for example, rental of apartments) are treated differently, depending on whether they are conducted by a large limited partnership (which may even be publicly offered) or by a passthrough PTP, even though a given activity produces the same income and losses.

C. PSCs

The OBRA explanation for eliminating inside graduated income tax rates for PSCs is overly terse, probably due to the inherent difficulty in distinguishing PSCs from close C corporations in general under a deep structure analysis.

The personal service income of a corporation owned by its employees is taxed to the employee-owners at the individual graduated rates as it is paid out as salary. The committee believes that it is inappropriate to allow the retained earnings to be taxed at the lower corporate graduated rates.³⁰¹

The 1984 Treasury proposals would have repealed the graduated corporate rates for *all* corporations in order to fund a general reduction of corporate rates³⁰² and to eliminate the use of closely-held corporations as inside tax shelters.³⁰³ These proposals provided no deep structure analysis, but simply stated that a progressive corporate income tax served no affirmative purpose.³⁰⁴

The Joint Committee staff, however, exposed the deep policy considerations in the 1986 passthrough entities hearing pamphlet:

In the absence of the factors noted above [continuity of life, centralized management, limited liability, and free transferability of interest], it may be viewed as inappropriate to treat an entity as a separate taxable unit. For example, to the extent that the entity is merely an agent or alter ego of the owner, it may be argued that the owner truly earns any income nominally earned by the entity,

³⁰⁰ See Rock & Shaviro, *supra* note 85, at 12-15, 26-27.

³⁰¹ 1987 House Report, *supra* note 21, at 1081.

³⁰² See 1984 Treasury Proposals, *supra* note 9, at 128.

³⁰³ See *id.*

³⁰⁴ *Id.* Actually, the graduated inside corporate brackets were enacted as an aid to capital formation in small corporations. See authorities cited in *supra* note 28.

and that the owner controls both the process of earning it and the income itself. Similarly, when an entity has relatively few owners, the audit and administrative difficulties of imposing taxation on the owner level are relatively manageable.³⁰⁵

In short, the application of inside graduated corporate rates to an entity in which the owners materially participate violates horizontal equity by generating less current taxation on retained earnings than does direct taxation of the owners. To make matters worse, the second-tier shareholder tax on owner-level realizations of such earnings is often de minimis.

OBRA's failure to provide any special one-shot, tax-free reincorporation provision to accompany the repeal of graduated rates for PSCs (as Congress provided in 1982 when it eliminated the retirement plan incentive for professional service corporations)³⁰⁶ indicates that Congress expected PSCs to elect S corporation status.³⁰⁷ In the absence of such election, the penalty for disallowed deductions by a PSC operating as a C corporation will be high.³⁰⁸ However, S corporations are treated as separate entities as to pass-through of income and losses and in other ways. In contrast to partnerships, "corporate liabilities are not included in a shareholder's basis for his interest in the [S] corporation, and special allocations are not [permitted.]" Also unlike partnership treatment, a "transferee of an S corporation interest is not entitled to 'step-up' the basis of his share of the entity's assets to reflect his purchase price."³⁰⁹ Thus, the post-OBRA tax treatment of PSCs still ignores the deep structure of entity classification.

More significantly, elimination of the inside corporate graduated rates was too narrow. Assistant Secretary Mentz acknowledged in the 1986 passthrough entity hearings that many close C corporations as a practical matter do not manifest the traditional corporate characteristics of continuity, centralized management, limited liability and free transferability,³¹⁰ but he rationalized continued C corporation treatment on the certainty and fairness of objective

³⁰⁵ 1986 Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17.

³⁰⁶ See *supra* note 109.

³⁰⁷ See *supra* note 110.

³⁰⁸ Since the owner controls the business and the entity, expenditures for a non-business purpose should be taxed at the owner's marginal rate.

³⁰⁹ 1987 Senate MLP Hearings, *supra* note 7, at 11.

³¹⁰ See 1986 Passthrough Entity Hearings, *supra* note 8, at 19, 28.

rules.³¹¹ The apparent political reality is that once Congress had fashioned the graduated small C corporate rates as a subsidy for capital accumulation,³¹² small business was determined to keep the subsidy. Indeed, the political response to the 1984 Treasury proposals to impose a flat corporate tax was quick;³¹³ the President's proposals of 1985 abandoned the idea,³¹⁴ and the Tax Reform Act of 1986 actually increased the subsidy by doubling the base (from \$25,000 to \$50,000) for the lowest corporate rate (15%),³¹⁵ violating horizontal and vertical equity principles. The stated rationale of the President's proposals of 1985 for retaining a graduated rate structure was specious, given that the various proposals and the final bill increased the corporate tax load to varying degrees.³¹⁶

The proposal retains a modified graduated rate structure for small corporations in recognition of the fact that complete elimination of the graduated rate structure would dramatically increase effective tax rates for many smaller corporations, thus nullifying the positive effects, for such corporations, of the proposed reduction in the maximum marginal rate.³¹⁷

V. TAX LEGISLATIVE PROCESS: POLICY AND POLITICS

A. 1954 Code General Pattern

The 1986 Code marks the end of one era of tax reform and the beginning of another. The second half of the 1954 Code era (comprising the 1970s and 1980-81), encompassed a period in which inflation-driven individual bracket creep³¹⁸ permitted Congress to enact current spending programs depending on the revenue windfall of expected future bracket creep to produce a balanced budget.³¹⁹ Congress periodically used budget surpluses produced

³¹¹ See *id.* at 27-28.

³¹² See authorities cited in *supra* note 28.

³¹³ See Birnbaum & Murray, *supra* note 23, at 80.

³¹⁴ See 1985 President's Proposals, *supra* note 9, at 117.

³¹⁵ See I.R.C. § 11(b).

³¹⁶ See 1986 Senate Report, *supra* note 8, at 28 (H.R. 3838 as passed by the Senate); H.R. Rep. No. 426, 99th Cong., 1st Sess. 65 (1985) [hereinafter 1985 House Report] (H.R. 3838 as passed by the House); 1984 Treasury Proposals, *supra* note 9, at 461.

³¹⁷ 1985 President's Proposals, *supra* note 9, at 119.

³¹⁸ See Simmons, *supra* note 271, at 156-57.

³¹⁹ See Leonard, *supra* note 48, at 972; Proceedings of Symposium on the Tax Reform Act of 1986, 31 Vill. L. Rev. 1787, 1791-1792 (statement of David Brockway, Chief of Joint

by such bracket creep to fund "tax reform." Thus, for example, the bottom two million or so working poor were periodically removed from the federal income tax roll³²⁰ (but bracket creep promptly would put them back on the roll), middle-income individuals were given cosmetic tax cuts,³²¹ and large, capital-intensive corporations and high-income individuals were provided increasing "tax expenditures" or preferences³²² (the preferences in both cases usually enhanced by leveraging techniques³²³), thereby reducing the tax base.³²⁴

As a result of these preferences, by the end of the 1954 Code era, many large C corporations and their shareholders had gone beyond integration (where at least one tax is collected) to the enjoyment of a practical repeal of the progressive rate feature of the income tax system, which traces its origins to the populist movement of the early twentieth century.³²⁵ Neither large corporations nor their shareholders (which included high-income individuals and tax-exempt organizations) paid much tax during the last years of the 1954 Code.³²⁶ The middle-income individual taxpayers bore the brunt of erosion of the corporate tax and high-income individual tax bases under the 1954 Code era.³²⁷

The Economic Recovery Tax Act of 1981,³²⁸ President Reagan's

Comm. Staff) [hereinafter Symposium on 1986 Act].

³²⁰ See Simmons, *supra* note 271, at 158.

³²¹ See Kies, *supra* note 51, at 181; Simmons, *supra* note 271, at 158, 160; Verdier, *supra* note 233, at 172. Tax expenditures or preferences are discussed *infra* note 322.

³²² See Kies, *supra* note 51, at 180; Leonard, *supra* note 49, at 971-972.

³²³ Many commentators believed that the combination of leverage and preferences constituted the core of tax shelter abuse. See *infra* note 333. Not surprisingly loss partnerships tend to be highly leveraged. See High-Income Taxpayer Hearings, *supra* note 46, at 11 (statement of Ronald Pearlman).

³²⁴ See Chirelstein, *supra* note 32, at 219-21; Simmons, *supra* note 271, at 198. The corporate income tax declined between 1950 and 1985 from 27% to 8% of total budget receipts and from 40% to 16% of total income tax receipts. See 1985 House Report, *supra* note 316, at 55.

³²⁵ See Birnbaum & Murray, *supra* note 23, at 6-8; Simmons, *supra* note 271, at 154, 168-69.

³²⁶ See, e.g., Chirelstein, *supra* note 32, at 211; *supra* note 43.

³²⁷ See Future Implications of 1986 Act Hearings, *supra* note 49, at 49 (statement of Lawrence Chimerine); Simmons, *supra* note 271, at 155-62.

³²⁸ "The Economic Recovery Tax Act of 1981 . . . gave taxpayers the largest tax cut in American history. . . ." Doernberg & McChesney, *Doing Good or Doing Well? Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. Rev. 891, 894 n.19 (1987).

first step in his tax policy revolution,³²⁹ which shifted the focus of taxation from the ability to pay and use of tax preferences to flat rates and level playing fields, contained three changes which ultimately set the stage for the reforms of the 1986 Code.³³⁰ First, the indexing of brackets for inflation and personal exemptions would eliminate bracket creep after the 1985 effective date.³³¹ Second, the combination of rapid capital recovery under ACRS and ITC (which were designed to approximate complete expensing of equipment in the year of acquisition),³³² plus leverage,³³³ virtually eliminated the tax base for many large corporations and half of high-income individuals.³³⁴ So that large loss corporations could enjoy the stimulus

³²⁹ See Chirelstein, *supra* note 32, at 208; Simmons, *supra* note 271, at 168-169 (explaining how the revolution commenced in 1981 continues to work under the 1986 Code). See generally Minarik, *supra* note 23, at 1372.

³³⁰ See Chirelstein, *supra* note 32, at 219; Minarik, *supra* note 23, at 1363, 1372 (1987).

³³¹ See Internal Revenue Code of 1954 § 1(f) (1985); Symposium on the 1986 Act, *supra* note 319; Chirelstein, *supra* note 32, at 219 and n.32; Leonard, *supra* note 48, at 972; Verdier, *supra* note 233, at 172.

³³² See Steines, *Income Tax Allowances for Cost Recovery*, 40 *Tax L. Rev.* 483, 537-538 (1985); Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 *Tax Law.* 549, 554 (1985).

³³³ See Cohen Symposium, *supra* note 156, at 593 (statement of Alvin Warren) ("if you move towards expensing, to be consistent you also have to set up a regime in which there is no deductibility of interest"); Warren, *supra* note 332, at 554.

³³⁴ In a recent study by a public interest group of 275 selected large corporations, almost half (129) managed to pay no federal income tax in at least one of the four years from 1981 to 1985, and the average effective rate for the four year period was 15%. See *Citizens for Tax Justice, Corporate Taxpayers & Corporate Freeloaders*, reprinted in 29 *Tax Notes* 947, 948, 949 (Dec. 2, 1985). The industry response that such studies ignore deferred tax liabilities, see Egger, *Citizens for Tax Justice's Latest Misrepresentation of Corporate Tax Burdens*, 29 *Tax Notes* 956 (Dec. 2, 1985), is misplaced if such liabilities can be deferred for sufficiently long periods or the liability constantly increases. Accelerated depreciation and the investment tax credit accounted for the lower effective rates for most of the surveyed corporations. See *Citizens for Tax Justice*, *supra* at 951. Similarly, a Treasury study of high income individual taxpayers found that 11% paid less than 5% of their total positive income in taxes, over one-half paid less than 20%; over 75% paid less than 30% and only 5% paid taxes of at least 40% of total positive income. See *High-Income Taxpayer Hearings*, *supra* note 46, at 18 (statement of Ronald Pearlman) (1983 data). Among high income, low tax returns, partnership losses dominate, with 77% showing some partnership losses. See *id.* at 18. Sixty-four percent of all high income taxpayers in 1983 reported some partnership loss. See *id.* at 19. While Treasury data did not permit pinpointing the sources of tax preference generating this pattern of partnership losses, interest, depreciation and mineral exploration costs in the aggregate accounted for near 40% of all partnership sector deductions. See *id.* at 23. This suggests a possible basis for the similar pre-1986 Act effective tax rates for corporations and high-income individual taxpayers (21% for corporations and 19 to 22% for individuals), since both used leverage and preferences heavily, see *supra* note 43. See generally *Future Implications of 1986 Act Hearings*, *supra* note 49, at 15 (statement of Rob-

of capital recovery, ERTA also authorized the "safe harbor" lease or sale of capital recovery tax benefits between corporate taxpayers.³³⁵ Third, ERTA combined these "business" tax cuts with high- and middle-income individual tax cuts.³³⁶

The tax cuts and accelerated capital recovery, in combination with increased defense spending and the 1981-82 recession, produced unprecedented deficits and, without bracket creep as a source of payment, created the structural impetus for major tax change.³³⁷ Perceived popular outrage grew as big ticket "safe harbor lease" tax benefit sales were widely publicized.³³⁸ At about the same time, Robert McIntyre, a public interest advocate, exposed avoidance of the corporate income tax by big corporate sector America.³³⁹ The 1981 capital recovery changes equally drove the individual side tax shelter explosion in the first half of the 1980s.³⁴⁰ These structural and political forces set the stage for tax reform which increased the corporate tax and finally eliminated individual passive use of tax preferences to shelter outside portfolio or business/professional income.³⁴¹

Probably of the same order of importance in the drive toward eventual post-ERTA tax reform were the actors on the tax reform stage: a strong Republican president and a largely Democratic Congress.³⁴² During the 1954 Code era, the major tax reform at-

ert McIntyre).

³³⁵ See Chirelstein, *supra* note 32, at 220; Minarik, *supra* note 23, at 1364.

³³⁶ [T]his Congress has also cut taxes [in 1981]; and that is at is part of the reason why our Federal budget deficit is as high as it is. I am not saying it is the sole reason, but I think most honest observers conclude that it is part of the reason, in addition to defense spending, that has caused the high Federal budget deficit that we now have. 1987 Senate MLP Hearings, *supra* note 7, at 140 (statement of Sen.Baucus).

³³⁷ See Verdier, *supra* note 233, at 173.

³³⁸ See Birnbaum & Murray, *supra* note 23, at 11.

³³⁹ R. McIntyre, *Corporate Income Taxes in the Reagan Years: A Study of Three Years of Legalized Tax Avoidance* (1984). See also Birnbaum & Murray, *supra* note 23, at 11-13; Minarik, *supra* note 23, at 1370. This not only disclosed the ready revenue increase source to pay for the traditional individual tax cut sweetener accompanying tax reform, see *supra* notes 318-322 and accompanying text, but also allowed Secretary of Treasury Donald Regan to sell the President on the corporate sector increase as resting on corporations who currently paid no taxes. See Minarik, *supra* note 23, at 1368.

³⁴⁰ See Birnbaum & Murray, *supra* note 23, at 10; *supra* note 334.

³⁴¹ See generally Simmons, *supra* note 271.

³⁴² See Leonard, *supra* note 48, at 970 ("Republican Presidents have had far more success in the tax legislative process than Democratic Presidents over the last 30 years."); Minarik, *supra* note 23, at 1368 (describing President Reagan's ability to sell a significant increase in

tempts by Democratic presidents (Kennedy in 1964³⁴³ and Carter in 1979³⁴⁴), with their party in control of Congress, were unsuccessful, probably due as much to the windfall revenue from bracket creep, which was used to fund tax expenditures, as to lack of control over their party. Nor was Congress able to slow down, much less completely halt shelter abuse when, due to the force of public opinion,³⁴⁵ it took the lead under Republican presidents (Nixon in 1969³⁴⁶ and Ford in 1976³⁴⁷). The congressionally-dominated tax acts of 1982 and 1984 were the result of especially severe budget pressures and revenue reconciliation directives.³⁴⁸ These latter two congressional acts, while raising large amounts of revenue, did not effectively halt shelter use and added great complexity with often ad hoc solutions.³⁴⁹ Significantly, the 1982 and 1984 acts did *not*

the corporate sector tax to Republican Congressmen as a "Nixon Visits China" scenario), 1369-70 (describing President Reagan's role in getting Chairman Rostenkowski's bill out of the House); Verdier, *supra* note 233, at 174.

³⁴³ President Kennedy's first tax bill instituted the quintessential tax preference—the investment tax credit—and his 1963 structural reforms by-and-large failed in the Democratic controlled Congress. See 131 Cong. Rec. H12,243 (daily ed. Dec 17, 1985); Birnbaum & Murray, *supra* note 23, at 14; Leonard, *supra* note 48, at 970. However, in a sense, President Kennedy's reform efforts bore limited fruit during the first term of President Nixon in the Tax Reform Act of 1969. See *infra* note 346.

³⁴⁴ President Carter's proposals through Secretary of the Treasury Blumenthal in 1977, e.g., concerning integration and elimination of the capital gains preference, met fierce opposition from interest groups. This probably led to the legislative defeat of the modest proposals the President introduced in 1978. See Birnbaum & Murray, *supra* note 23, at 15-16; Leonard, *supra* note 48, at 970-71.

³⁴⁵ Leonard, *supra* note 48, at 971.

³⁴⁶ At the conclusion of President Johnson's administration, and in response to public demand created by the publicizing of high income-low tax individual income taxpayer's by Secretary of the Treasury Barr and the 1969 release of Treasury's Tax Reform Studies and Proposals, prepared under Professor Stanley Surrey, the Assistant Treasury Secretary for Tax Policy, the House held tax reform hearings in the first month of President Nixon's first term, hearings which ultimately led to the Tax Reform Act of 1969. See Birnbaum & Murray, *supra* note 23, at 14 (Act "repealed the investment credit, ended or curtailed a number of other tax breaks, and cracked down on tax-exempt foundations"); Leonard, *supra* note 48, at 971 (largely finding a policy foundation in Surrey tax reform studies); Verdier, *supra* note 233, at 174 ("The Tax Reform Act of 1969 gained its impetus from the sharp increase in tax burdens following the 1968 Vietnam War surcharge, and the revelation . . . that hundreds of wealthy Americans were completely escaping taxation.").

³⁴⁷ "The Tax Reform Act of 1976 followed the sharp increase in Democratic majorities in the Congress and the weakening of the presidency produced by Watergate." Verdier, *supra* note 233, at 174.

³⁴⁸ See *id.*

³⁴⁹ The 1982 and 1984 tax acts and the 1983 Social Security Act were the largest tax increases in peace time history. See Symposium on 1986 Act, *supra* note 319, at 1791 (state-

increase rates (recently cut in ERTA in 1981), nor did they repeal indexing.³⁵⁰ Against this backdrop, President Reagan and the tax writing committee chairmen helped produce the 1986 Act.

B. 1986 Code General Pattern

President Reagan, in 1985-86, was able to set the parameters for structural tax reform and hence the shape of the 1986 Code. First, there could be no net revenue increase over the base period. Second, a corporate sector increase could carry an individual sector tax cut. Finally, top individual rates had to be lowered to no higher than 35% (the lowering of the corporate rate was largely symbolic for most, but not all, big C corporations).³⁵¹ Congressional political considerations added the proviso that individual tax cuts could not disproportionately benefit high-income taxpayers³⁵². This political reality had the effect of locking in the more recent erosion of progressivity as to high bracket taxpayers³⁵³ (as former Senator Haskell pointed out³⁵⁴), but may have been politically necessary to cut off an attack on the 1986 Act by such taxpayers as a "redistributionist scheme."³⁵⁵ Finally, Chairmen Rostenkowski of the

ment of Brockway).

³⁵⁰ See *id.*

³⁵¹ The proscription of no net increase in tax revenues from the individual and corporate tax sectors *taken in the aggregate* was indeed written in stone. See Birnbaum & Murray, *supra* note 23, at 87. The maximum individual rate of 35% was negotiable. See *id.* at 86, 143, 153. Indeed, the President supported the House bill with a 38% maximum rate, albeit with the hope of doing better on the Senate side. See *id.* at 173-74. It is unclear whether the President fully understood the critical role of the offsetting corporate sector tax increase for an individual sector tax cut, at least at the beginning. See *id.* at 63, 77; Minarik, *supra* note 23, at 1368. Whether it was understood or not by Reagan, that increase allowed a traditional individual sector tax cut, probably a necessary element to the passage of the Tax Reform Act of 1986. See Birnbaum & Murray, *supra* note 23, at 60. And probably only Reagan, a popular conservative Republican president, could persuade enough Republican Congressmen to support such a corporate tax increase on one of their main constituent groups, businessmen. See *id.* at 60, 171; Minarik, *supra* note 23, at 1368.

³⁵² See Kies, *supra* note 51, at 183; 1986 Senate Report, *supra* note 13, at 714 ("[A] provision significantly limiting the use of tax shelter losses is unavoidable if substantial rate reductions are to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax that is borne by high-income taxpayers as a group.").

³⁵³ See Kasten & Sammartino, *supra* note 187, at 77.

³⁵⁴ See Haskell, *Tax Reform*, 35 *Tax Notes* 301, 303 (Apr. 20, 1987).

³⁵⁵ See Minarik, *supra* note 23, at 1365 (because the Bradley-Gephardt bill did not raise any income class of individuals or the corporate sector taken as a whole, it could not be attacked as a redistributionist scheme).

House and Packwood of the Senate tax writing committees adopted procedural rules in committee (and later used in the Senate) requiring that any revenue-losing amendments be offset by revenue raisers.³⁵⁶ Add the ingredients of presumed popular outrage at high-income, low-tax individual and corporate taxpayers who paid little or no tax³⁵⁷ and the political considerations already manifested in the President's 1985 proposals, including the retention of the home mortgage interest and accelerated capital recovery deductions (provisions which were either "sacred cows"³⁵⁸ or "original sins,"³⁵⁹ depending on one's point of view, but politically non-repealable in any event) and the final contours of the 1986 Act appear³⁶⁰ almost inevitable in retrospect. The actual story, as told in *Showdown at Gucci Gulch*,³⁶¹ is fascinating and might even be suspenseful if we didn't already know the ending.³⁶²

Structurally the 1986 Act presents many familiar 1954 Code tax reform features, but at the same time it constitutes something new. The 1986 Act contains the traditional individual tax reduction sweetener³⁶³ and again takes large numbers of working poor off the tax rolls.³⁶⁴ The pattern as to preferences or tax expenditures is more complex, however. In comparison to the 1954 Code, the drafters of the 1986 Code substantially scaled back or eliminated some capital recovery tax expenditures, particularly the investment tax credit and capital recovery as to real estate,³⁶⁵ although the tax expenditures as to personal property remained about the

³⁵⁶ See *id.* at 1369, 1371.

³⁵⁷ See *id.* at 1371. Clearly taxpayers have lost faith in the Federal tax system. See 1986 Senate Report, *supra* note 7, at 713. The question is whether skepticism is now so rooted that the majority of individual taxpayers do not believe that the 1986 Tax Reform Act benefits them. Cf. *Future Implications of 1986 Act Hearings*, *supra* note 49, at 46, 146.

³⁵⁸ See generally 1985 President's Proposals, *supra* note 9, at 132-59.

³⁵⁹ See Brannon, *Tax Loopholes as Original Sin: Lessons From Tax History*, 31 *Vill. L. Rev.* 1763 (1986).

³⁶⁰ See Kies, *supra* note 51, at 184.

³⁶¹ See *supra* note 23.

³⁶² The Tax Reform Act of 1986 was, indeed, a cliff-hanger at the time. See Yorio, *supra* note 30, at 395 n.2 ("The road through Congress was tortuous.").

³⁶³ See *id.* at 1372.

³⁶⁴ See *Future Implications of 1986 Act Hearings*, *supra* note 49, at 15 (statement of Robert McIntyre); Simmons, *supra* note 271, at 161, 164.

³⁶⁵ The ITC was repealed retroactively to the beginning of the 1986. The ACRS life for real estate was extended from approximately 50%, from 19 years to 29-30 years; and front-loaded 175% declining balance rate slowed to straight line. See, e.g., Simmons, *supra* note 271, at 199.

same.³⁶⁶ Under Doernberg and McChesney's "tax contracts" analysis, forestalling legislation more harmful to special interests may be viewed as preferential treatment of such interests;³⁶⁷ and in this

³⁶⁶ The ACRS deduction for personal property was actually accelerated through a more front-loaded rate to partially offset the repeal of the ITC. See 1986 Senate Report, *supra* note 8, at 96; Simmons, *supra* note 271, at 197-99; Sunley, *supra* note 23, at 64. Congress' rationale in the House paid lip service to economic efficiency and reasoned that accelerated depreciation had not stimulated investment in depreciable property, and, in turn had pulled the entire economic into more rapid growth. See 1985 House Report, *supra* note 316, at 145-46. Nevertheless the House believed, without explaining why some preferences for investment in depreciable property should be maintained, that pre-1981 depreciation should be the right target. See *id.* The Senate supplied the why's, and like the final legislation, enriched personal property ACRS, while paying even less credible lip service to economic efficiency.

The committee believes some further acceleration in the rate of recovery of depreciation deductions should be provided to compensate partly for the repeal of the investment tax credit. The committee is cognizant that other nations heavily subsidize business investments through tax and other policies, and the committee does not believe such policies can be completely ignored. Therefore, it was the committee's judgment that to maintain the international competitiveness of U.S. business changes were necessary to the accelerated cost recovery system which, in certain cases, provided greater incentives than those existing under present law. The bill increases the rate of acceleration from 150-percent declining balance to 200-percent declining balance for property in the 5-year and 10-year classes. Together with the large tax rate reductions, investment incentives will remain high and the nation's savings can be utilized more efficiently.

The committee believes an efficient capital cost recovery system is essential to maintaining U.S. economic growth. As the world economies become increasingly competitive, it is most important that investment in our capital stock be determined by market forces rather than by tax considerations.

Under present law, the tax benefits arising from the combination of the investment tax credit and accelerated depreciation are more generous for some equipment than if the full cost of the investment were deducted immediately—a result more generous than exempting all earnings on the investment from taxation. At the same time, assets not qualifying for the investment credit and accelerated depreciation bear much higher effective tax rates. The output attainable from our capital resources is reduced because too much investment occurs in tax-favored sectors and too little investment occurs in sectors that are more productive, but which are tax-disadvantaged. The nation's output can be increased simply by a reallocation of investment, without requiring additional saving.

The committee believes the surest way of encouraging the efficient allocation of all resources and the greatest possible economic growth is by reducing statutory tax rates. A large reduction in the top corporate tax rate can be achieved by repealing the investment tax credit without reducing the corporate tax revenues collected. One distorting tax provision is replaced by lower tax rates which provide benefits to all investment. A neutral tax system allows the economy to most quickly adapt to changing economic needs.

1986 Senate Report, *supra* note 8, at 96.

³⁶⁷ See Doernberg & McChesney, *supra* note 34, at 933-34, 942-45 (buying and selling

vein both the President's proposals and the Senate Finance Committee bill had convenient foils.³⁶⁸

The 1986 Code's direct treatment of these tax expenditures tells only half the story. Responding in part to the popular opposition to individual tax shelters and corporate giants who paid no tax,³⁶⁹ and even more to the tax revenues inherent in indirectly curtailing the tax expenditures eroding the high income individual and corporate sector tax bases, Congress enacted in the 1986 Act the passive loss rules,³⁷⁰ repealed the capital gains preference³⁷¹ and strengthened the individual and corporate alternate minimum tax.³⁷² Thus, in effect, the 1986 Act lessened the benefits of capital recovery and tax preferences.³⁷³ Moreover, these complex and often inelegant³⁷⁴ provisions, indirectly producing base broadening, gen-

legislation).

³⁶⁸ See Minarik, *supra* note 23, at 1368-69.

³⁶⁹ See *supra* notes 339-341 and accompanying text.

³⁷⁰ I.R.C. § 469. This provision is estimated to result in a \$23.4 billion revenue increase over the years from 1987 to 1991. See 1986 Bluebook, *supra* note 51, at 254.

³⁷¹ Pub. L. No. 99-514 § 301 (repealing I.R.C. § 1202). Separate capital gains repeal revenue figures are not broken out. See 1986 Bluebook, *supra* note 51.

³⁷² See Pub. L. No. 99-514 § 701. Individual and corporate minimum tax provisions should increase the fiscal budget receipts for the years from 1987 to 1991 by \$8.2 billion for individuals and \$22.2 billion for corporations. See 1986 Bluebook, *supra* note 51, at 473.

³⁷³ See Yorio, *supra* note 30, at 439. In essence, the 1984 Treasury Proposals constitute a "free market manifesto" as to capital recovery, as well as most other tax rules. See McLure, *Where Tax Reform Went Astray*, 31 Vill. L. Rev. 1619, 1625 (1986) (a principal architect of the 1985 Treasury Proposals). Congress recognized the wisdom of economic efficiency instead of preferential treatment, see *supra* note 308, but was subject to the intense lobbying by, and PAC contributions from, the special interests and yielded to them (other than real estate with its see-through office buildings). On the other hand, Congress effectively restricted such capital recovery deductions to corporations and individual's actively participating in the activity; and even then, the tax preferred taxpayer must pay a "minimum tax." See *High-Income Taxpayer Hearings*, *supra* note 46, at 66-68, 98-99 (statements of Ronald Pearlman, Reps. Dorgan, Thomas, and Pease). Thus, the 1986 Code constitutes here a compromise between economic efficiency and tax expenditures for capital intensive activities, but at least rate reduction was achieved. See generally *Future Implications of 1986 Act Hearings*, *supra* note 49, at 67 (statement of Alan Greenspan).

³⁷⁴ A leading commentator on tax reform (and consultant to Senator Bill Bradley on his rate-lowering through base broadening proposals) described the 1984 Treasury Proposals for dealing with inflation by indexing capital recovery, inventories, and loans as "elegant." See 1984 Treasury Proposals, *supra* note 9, at 177-200; Minarik, *supra* note 23, at 1367.

In these respects, Treasury I was the antithesis of Bradley-Gephardt's creed of practicality over purity. Many economists reacted that the Treasury was sending a Lamborghini out to race the Bradley-Gephardt Volkswagen Beetle.

But Lamborghinis often fail to start on cold mornings, and what was picked apart in Treasury I, was for the most part, the elegant features. The financial community

erated the revenues to support Senator Bill Bradley's idea³⁷⁵ of substantially lower marginal rates, the force of which ignited consideration, passage and signing of the 1986 Act.³⁷⁶ Such indirect base broadening rendered the 1986 Act palatable to both those who desired horizontal equity or fairness and those who desired economic efficiency.³⁷⁷ The cost was abandonment of vertical equity or progressivity,³⁷⁸ but vertical equity had long been unrealized in any event, due to tax expenditures.³⁷⁹ Some, including the author, fear that reintroduction of high rates would inevitably lead Congress to fashion more of such expenditures, which are utilized mostly by high-income individual taxpayers and corporate giants and which ultimately increase effective rates for middle-income taxpayers.³⁸⁰ In addition to its low rates (which more closely approached actual effective rates),³⁸¹ the 1986 Act more importantly eased, although it did not erase, horizontal disparity at the high end of the individual and corporate taxpayer levels.

C. OBRA PTP-PSC Changes and the Tax Legislative Process

In 1983, the Assistant Secretary of the Treasury for Tax Policy, Ronald Pearlman, testified at the Senate Finance Committee hearings on reform of corporate taxation that study of any classification issue should look at the entire business entity continuum:

argued against indexation of capital gains for the same reason that they had in 1978: they preferred an exclusion that would reward them for big gains accrued over short times, rather than inflation protection. The investment community railed against nonaccelerated indexed depreciation, asking for bigger up-front deductions that were not contingent upon inflation. Banks found that the streamlined indexation of interest income and expense would distort their profit margins.

Id.

³⁷⁵ See *id.* at 1370, 1372, 1373.

³⁷⁶ See Birnbaum & Murray, *supra* note 23, at 223, 228, 233, 259.

³⁷⁷ See Bittker, *Tax Reform—Yesterday, Today, and Tomorrow*, 44 *Wash. & Lee L. Rev.* 11, 14 (1987); Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code*, 55 *Fordham L. Rev.* 885, 886-89 (1987).

³⁷⁸ See Haskell, *supra* note 354, at 303.

³⁷⁹ See 1959 Panel Discussions, *supra* note 23, at 861 (statement of Paul Ziffren).

³⁸⁰ See Symposium on 1986 Act, *supra* note 319, at 1792 (statement of Brockway) (1986 Act promotes fairness); Cordes & Galper, *Tax Shelter Activity: Lessons From Twenty Years of Evidence*, 38 *Nat'l Tax J.* 305, 322 (1985). But *c.f.* Schurtz, *A Critical View of Traditional Tax Policy Theory: A Pragmatic Alternative*, 31 *Vill. L. Rev.* 1665, 1684 n.89 (1986) (fairness is counterproductive).

³⁸¹ See *supra* note 43.

Questions such as how a type of organization should be taxed, whether as a so-called C-corporation, an S- corporation or as a partnership or, for that matter, as a real estate investment trust or a regulated investment company, require, we believe, an analysis of all of those classification situations. We suspect that if that analysis were undertaken, we would not agree to base tax classification on the degree of marketability of an organization's equity interests.³⁸²

Similarly, Chairman Rangel in commencing the 1986 Select Revenue Measures Subcommittee hearings on issues relating to pass-through entities announced that the purpose of the initial hearing was "to obtain a broad overview of tax policy issues affecting pass-through entities. . . . The subcommittee is particularly concerned that specific, ad hoc modifications in this area not be made without consideration of the overall impact of such modifications on the passthrough entity area."³⁸³

The 1986 and 1986 Joint Committee staff hearing pamphlets on passthrough entities³⁸⁴ and master limited partnerships,³⁸⁵ respectively, and Assistant Secretary Mentz' 1986 statement,³⁸⁶ fortunately do provide such a broad overview and analysis, which might have produced tax policy at its best. Unfortunately, politics dominated as the specific, ad hoc modifications implemented in OBRA as to PTPs were put in place.³⁸⁷ Consequently, the criterion chosen (public trading of partnership units) was two steps removed from the deep structure ideal of material participation³⁸⁸ and the remedy provided (corporate treatment) was deficient technically.³⁸⁹

Similarly, the 1984 Treasury proposals pointed the way to a policy analysis of close C corporations,³⁹⁰ which the 1986 passthrough entity hearing pamphlet briefly provided, also properly resting on material participation.³⁹¹ But again politics prevailed with the OBRA criterion for elimination of the inside shelter (professional

³⁸² Reform of Corporate Taxation Hearings, *supra* note 9, at 11.

³⁸³ 1986 Passthrough Entity Hearings, *supra* note 8, at 1.

³⁸⁴ See *supra* note 19.

³⁸⁵ See *id.*

³⁸⁶ See *supra* note 8.

³⁸⁷ See *supra* notes 144-145 and accompanying text.

³⁸⁸ See *supra* notes 260-264 and accompanying text.

³⁸⁹ See *supra* notes 189-198 and accompanying text.

³⁹⁰ See *supra* notes 216, 302-304 and accompanying text.

³⁹¹ See Passthrough Entity Hearing Pamphlet, *supra* note 8, at 17; *supra* note 305 and accompanying text.

services) being too narrow;³⁹² and the remedy (elimination of graduated rates) technically deficient.³⁹³ Standing alone, then, the 1987 PTP and PSC provisions represent a failure of policy, possibly lessening the impetus for true deep structure, policy-based reform.

One should not be overly pessimistic about future prospects, however.³⁹⁴ OBRA's general tone may indicate the direction of tax revisions over the next five years or so. That direction should be: maintenance of low individual and corporate rates with incremental base broadening,³⁹⁵ directed by the budget revenue reconciliation process³⁹⁶ and derived (as in the case of the PTP and PSC provisions) from earlier, broader Treasury and Joint Committee studies.³⁹⁷ To the extent future tax revisions thus reverse the dominant, but not exclusive pattern of 1954 Code "reform" by gradually broadening the base, rather than gradually narrowing it³⁹⁸ (note that Chairman Rostenkowski now appears to favor the base broadening course³⁹⁹), consistent treatment of all large limited partnerships in which most owners do *not* materially participate and of all entities in which the owners *do* materially participate might at last be obtained.

³⁹² See supra note 217 and accompanying text.

³⁹³ See supra notes 306-309 and accompanying text.

³⁹⁴ "Hope springs eternal in the human breast. Man never Is, but always To be blest." Alexander Pope, *An Essay on Man* [1733-34] Epistle I, 1.95.

³⁹⁵ This is the pattern of the 1982, 1984 and 1987 tax acts. See supra notes 48, 53 and accompanying text.

³⁹⁶ See *id.*

³⁹⁷ See supra note 54.

³⁹⁸ See supra notes 371-375 and accompanying text.

³⁹⁹ See supra note 55 and accompanying text.