TAXATION OF
MASTER LIMITED PARTNERSHIPS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE
ON JULY 21, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on July 21, 1987, on the tax treatment of master limited partnerships (also referred to as "MLPs.").

In its press release on the hearings dated June 30, 1987, the Subcommittee stated that the hearing would examine the impact, if any, of the use of master limited partnerships on the corporate income tax base. The Subcommittee also stated that it would consider this issue in the broad context of the corporate tax system generally and the effects of the Tax Reform Act of 1986 on businesses' choice of form of doing business.

This pamphlet,[1] prepared in connection with the Subcommittee hearing by the staff of the Joint Committee on Taxation, provides a description of present-law tax treatment of master limited partnerships and an analysis of the tax issues. Part I is an overview. Part II is a description of present law relating to the tax treatment of partnerships, S corporations, trusts, and other passthrough entities; the tax treatment of corporations and their shareholders; and master limited partnerships and the types of transactions by which MLPs are typically formed. Part III of the pamphlet contains an analysis of the Federal tax issues concerning tax treatment of master limited partnerships and other partnership tax issues.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Taxation of Master Limited Partnerships* (JCS-19-87), July 20, 1987.

I. OVERVIEW

Present law

For a number of business or other reasons, owners of a business or of income producing property may prefer to conduct the business or hold the assets in a separate entity. The tax consequences of using a separate entity depend on the type of entity that is used. Under present law, several types of entities may be treated for tax purposes as passthrough entities: i.e., entities that generally do not pay income tax themselves, but whose owners are subject to tax on income earned by the entity.

Some types of entities are treated principally as conduits, in that income and loss of the entity is normally taken into account directly by the owners. Examples of this generic type of passthrough entity are partnerships and S corporations. Other types of entities are not treated as pure conduits, in that losses are not passed through, but net income or distributions generally are subject to one owner-level tax rather than to tax at both the owner and the entity level. Examples include real estate investment trusts and regulated investment companies. Some trusts can also be characterized as, in effect, conduits; although a trust is generally taxed as a separate entity, it may deduct distributions to beneficiaries, who generally include the distributed amounts in their income. Grantor trusts are taxed as if the property held by the trust were still retained by the grantor.

By contrast, C corporations are not treated as conduits for tax purposes. Income or loss of a C corporation is taken into account for tax purposes at the corporation level, and determines the corporation's tax liability. Distributions by corporations to their shareholders are separately subject to tax in the hands of the shareholders in determining their own tax liability. Income of C corporations is thus said to be subject to two levels of tax: once at the corporate level when earned by the corporation, and again at the shareholder level when the corporation makes distributions to them.

Present law sets forth criteria applicable in distinguishing among types of entities that receive passthrough tax treatment, and in distinguishing such passthrough entities from C corporations. In general, applicable Treasury regulations provide factors for distinguishing among partnerships, corporations and trusts. In addition, special rules apply to certain types of passthrough entities, including S corporations, real estate investment trusts, regulated investment companies, real estate mortgage investment conduits, cooperatives, and housing cooperatives.

Among the entities that have been considered as partnerships under present law entity classification rules are those known as "master-limited partnerships", or "MLPs." The term refers to the two-tier structure of the partnership, and is commonly used to refer to limited partnerships that are publicly traded, for example, on securities exchanges (like corporate stock and securities), such as the New York Stock Exchange or the American Stock Exchange, or over-the-counter (e.g., through the National Association of Securities Dealers Automated Quotations ("NASDAQ"). This structure might also be used for other partnerships.[2]

Background

The phenomenon of master limited partnerships has attracted increasing attention.[3] Commentators have documented substantial growth in the number of master limited partnerships;[4] and some have asked whether MLPs (and other alternatives to corporate structure) might lead to the "disincorporation" of America.[5] At the same time, MLPs have been discussed as a creative new technique for investment.[6] The first master limited partnership was formed and sold to the public in 1981.[7]

Sales of new equity MLPs have accelerated since enactment of the Tax Reform Act of 1986: New equity (i.e., excluding rollups and liquidations) MLP sales were $1.751 billion in the first 5 months of 1987, 245 percent higher than during the same period in 1986.[8] As shown in Table 1, new equity MLPs increased from 18.8 percent of publicly offered limited partnership sales in 1986 to over 40 percent in the first 5 months of 1987. The ratio of new equity MLP sales to common stock offerings was 7.9 percent, as shown in Table 1.

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[2] The limited partnership laws of many states require filing a certificate of limited partnership that includes the names of all limited partners. If the ultimate interests in a partnership may trade frequently, a "Master" partnership can be organized in a State that does not require such a filing and interests in it may be offered to the public. The "master" partnership may then be the sole limited partner of a partnership conducting business in a state with the requirement. If the state requires that the names of the limited partners of the "master" partnership be filed, such filing may generally be made only periodically (e.g., monthly).

[3] See, e.g., "Oppenheimer Plans to Sell 30% Stake in Money Management Unit to Public," *The Wall Street Journal* (June 4, 1987) Sheppard, "Taxing Publicly Traded Limited Partnerships as Corporations," *Tax Notes* (April 6, 1987); Chambers and Lyman, "The True Facts About Publicly Traded Limited Partnerships," *Tax Notes* (May 18, 1987), "Some Master Limited Partnerships Offer High Yields but Post Poor Total Returns," *The Wall Street Journal* (March 19, 1987); "Real Estate: Master Limited Partnerships Expected to Flourish Due to Tax Bill," *BNA Daily Tax Report* No. 204 (October 22, 1986); "After Tax Law: A Surge in Sales of Partnerships," *The Wall Street Journal*, (June 11, 1982); "A New Financing Tool is in Trouble Already," *Business Week* (June 29, 1987).

[4] *Public Partnership Sales Update*, The Stanger Report (June 1987).

[5] " America Disincorporated?" *Forbes* (June 16, 1986); "Tax Reform's Tax Dodge," *Forbes* (October 20, 1986); 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," *Taxes* (December 1986).

[6] Lyman, "An Overview of the Origin and Tax Treatment of Publicly Traded (Master) Limited Partnerships," 13 *Tax Management Washington Tax Review* 113 (June 1987).

[7] Apache Petroleum Company (initial offering, January 23, 1981).

[8] Robert A. Stanger & Co. unpublished data.

Table 1.—Limited Partnership, MLP, and Common Stock Sales

[Dollar amounts in millions]

Year	Public Sales of LPs [1]	Sales of new Equity MLPs [2]	Ratio of new Equity MLPs to Total Public LP sales	Total MLP Offerings [3]	Gross Proceeds Primary Public Offerings of common stock [4]	Ratio of new Equity MLP sales to common stock offerings
1981	$4,884	NA	NA	$698	$14,238	NA
1982	$5,510	NA	NA	$724	$13,298	NA
1983	$8,347	NA	NA	$731	$29,525	NA
1984	$8,401	NA	NA	$358	$8,669	NA
1985	$11,549	NA	NA	$5,530	$18,348	NA
1986	$13,138	$2,475	18.8%	$4,097	$31,323	7.90%
May 1987	$4,265	$1,751	41.1%	NA	NA	NA
Growth rate:						
1981–86	21.9%	NA	NA	42.5%	17.1%	NA

[1] Sales of SEC registered limited partnerships; 1981 is estimated. Source: Robert A. Stanger & Co.
[2] Source: Robert A. Stanger & Co. (new equity MLPs exclude rollups and liquidations).
[3] Source: U.S. Dept. of Treasury, Office of Tax Analysis. Based on data contained in prospectuses and related information. All units offered to the public are not necessarily sold.
[4] Source: U.S. Securities and Exchange Commission, SEC Monthly Statistical Review, Table M-375.

II. PRESENT LAW AND BACKGROUND

The first section of Part II provides a brief description of the tax treatment, including entity classification rules where applicable, of partnerships and various other types of entities that are conduits or whose income is ordinarily subject to tax at the owner level rather than the entity level. Next is a brief description of the tax treatment of C corporations (i.e., those governed by Subchapter C of the Code), with a comparison of corporate and partnership tax treatment. The last section in this part is a description of the tax treatment of typical transactions in which master limited partnerships are formed and operated.

A. Passthrough Entities

1. Partnerships

In general

A partnership is not itself subject to Federal income taxation under present law, but rather, each partner takes into income his distributive share of the partnership's taxable income and the separately computed items of income, gain, loss, deduction or credit of the partnership (sec. 702(a)). The liability for Federal income tax payment is that of the partner, and not of the partnership (sec. 701).

Contributions of property to a partnership, in exchange for an interest in the partnership, generally do not give rise to recognition of gain or loss to the contributing partner or to the partnership (sec. 721).

Distributions from a partnership to a partner (other than in liquidation) generally also do not give rise to recognition of gain or loss to the distributee partner or to the partnership. A partner's basis in his interest is reduced by the amount of money and the basis of property distributed to him (sec. 733). Distributions of money in excess of the partner's basis for his partnership interest, however, do give rise to gain to the partner (sec. 731).

Payments in liquidation of a retiring or deceased partner's interest (that are not treated as a distributive share of partnership income or a guaranteed payment) are generally treated as distributions (sec. 736). The basis to a partner of property distributed in liquidation of his interest is equal to his basis in his interest, reduced by any money distributed in the same transaction (sec. 731(b)). A partner receiving property or money in exchange for all or part of his interest in the partnership must include in income his share of the partnership's unrealized receivables (which includes recapture and similar items) and his share of substantially appreciated inventory items (sec. 751).

Although current distributions to partners are generally not taxable to them, each partner includes in income his distributive share of partnership taxable income, whether or not he receives any corresponding distribution. A partner also takes account, in calculating his income, of separately computed items of partnership income, gain, loss, deduction or credit (sec. 702). This treatment reflects the conduit nature of partnerships.

A partnership may make an election under which each transferee of a partnership interest may step-up the basis of his share of partnership assets to reflect the purchase price paid for the partnership interest (secs. 754 and 743).

The foregoing treatment applies in the case of limited partnerships as well as general partnerships.

Partnership liabilities

In general, at the inception of the partnership, a partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. His basis is generally increased by an increase in his share of liabilities and decreased by a decrease in his share of them (among other factors that affect his basis) (sec. 752). A general partner's liability for his share of the partnership's liabilities is theoretically unlimited and so, as provided in Treasury regulations, a general partner's basis in his partnership interest is increased by partnership liabilities in accordance with his ratio for sharing losses under the partnership agreement (Treas. Reg. sec. 1.752-1).

A limited partner's share of partnership recourse liabilities, under the Treasury regulations, may not exceed the amount that the limited partner may be called upon to contribute under the partnership agreement. However, the regulations provide, with respect to partnership nonrecourse liabilities, that "where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits." Under this provision, a limited partner may increase his basis in his partnership interest by amounts of nonrecourse liabilities for which he has no payment obligation, and which could only affect him indirectly where the cost of debt service reduces his share of partnership taxable income, or the encumbered asset is claimed by the creditor (with no change in the net worth of the partnership).

A related rule provides a partner's distributive share of partnership loss for a taxable year is deductible only to the extent of his basis in his partnership interest (sec. 704(d)). The inclusion of partnership nonrecourse liabilities in a limited partner's basis for his partnership interest in effect increases the amount of partnership losses he can deduct for the year, although he may not have any obligation to pay the liability. The limitation of losses to the amount of the partner's basis may, in some cases, have little practical application if the partner is subject to other limitations on the deductibility of such partnership losses, such as the passive loss rule (which provides that losses from limited partnership interests are treated as passive and are limited to the amount of the taxpayer's passive income for the year (sec. 469)). The passive loss rule does not, however, apply to partners that are widely held corporations. Similarly, the at-risk rule, which generally limits deductions from an activity to the amount the taxpayer has at risk in the activity, does not apply to widely held corporations (sec. 465). Thus, the inclusion of partnership liabilities in a widely held corporate partner's basis in its partnership interest can permit such a partner to increase the amount of partnership losses it may apply to offset unrelated income.

Special allocations

Partners (limited and general) are subject to tax on their distributive shares of the partnership's taxable income or loss, and the partnership's separately computed items of income, gain, loss, deduction or credit (sec. 702). In general, if the partnership agreement does not provide as to the partner's distributive share, then his distributive share is determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances (sec. 704(b)).

Partnership income, gain, loss, deduction or credit (or items thereof) may be allocated under the partnership agreement among the partners in a manner that is disproportionate to the capital contributions of the partners. These arrangements are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)), except to the extent such allocations constitute retroactive allocations (sec. 706). If a partnership allocation does not have substantial economic effect, then the partner's share is redetermined in accordance with his interest in the partnership (sec. 704(b)(2)).

Treasury regulations describing when an allocation has substantial economic effect provide generally that to have economic effect, an allocation must be consistent with the underlying economic arrangement of the partners, and for the economic effect to be substantial, there must be a reasonable possibility that the allocation will affect the dollar amounts received by the partners, independent of tax consequences (Treas. Reg. 1.704-1(b)(2)(ii) and (iii)). Allocation of deductions attributable to nonrecourse debt, for which no partner is personally liable, is permitted (provided, *inter alia,* that the partnership agreement provides for a chargeback to the partner of the minimum gain attributable to the allocation based on the nonrecourse debt), even though, as the regulations state, such allocations cannot have economic effect (Treas. Reg. sec. 1.704-1(b)(4)(iv)(a) and (e)).

In general, principal and interest payments with respect to debt of the partnership are not treated as allocations of partnership income. Similarly, payments by the partnership as fees or compensation for services generally are not treated as allocations of income of the partnership. Rather, to the extent that such expenditures are deductible (e.g., interest, or fees that constitute ordinary and necessary business expenses), the deductions reduce partnership taxable income, and could be specially allocated under the partnership agreement (provided that the allocation of the deductions meets the criteria for having substantial economic effect).

Entity classification

The Supreme Court articulated standards applicable in determining whether an entity should be taxed as a corporation in the case of *Morrissey* v. *Commissioner,* 296 U.S. 344 (1935). The court reasoned that the entity in that case resembled a corporation. Thus, the *Morrissey* case is said to have set forth the "resemblance" test referred to in the Treasury regulations regarding entity classification. These regulations govern classification under present law.

In distinguishing partnerships from corporations for Federal income tax purposes, Treasury regulations provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an entity is to be classified as a partnership or a corporation depends on whether the entity has more than two of the remaining four principal corporate characteristics. The effect of the regulations generally is to classify an entity as a partnership if it lacks any two of them, without further inquiry as to how strong or weak a particular characteristic is or how the evaluation of the factors might affect overall resemblance (Treas. Reg. secs. 301.7701-2 and -3; *Larson* v. *Commissioner,* 66 T.C. 159 (1976), acq. 1979-1 C.B. 1).

These regulations, known as the "Kintner" regulations, were adopted in 1960 in response to the decision in *U.S.* v. *Kintner,* 216 F.2d 418 (9th Cir. 1954). In that case, a physician successfully sought to have his business association classified as a corporation rather than a partnership under the regulations, to take advantage of the more favorable pension plan rules applicable to corporations (as compared to partnerships) under the law in effect at that time. The regulations were revised in 1960 in response to the decision, to make it more likely that an association would be classified as a partnership and not a corporation.

The Tax Equity and Fiscal Responsibility Act of 1982 changed the favorable pension plan treatment of shareholders who are also corporate employees (as compared, for example, to partners). Thus, the original reason for changing the partnership classification regulations as they were changed in 1960 was removed.

In 1976, the Tax Court suggested that the regulations might not be operating effectively to identify those entities that had an overall corporate resemblance; however, the court concluded it was required to follow the regulations and held that a particular entity was classified as a partnership. *Larson* v. *Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1. A proposed revision of the regulations was issued in January, 1977 (42 Fed. Reg. 1038, January 5, 1977) but was withdrawn almost immediately (42 Fed. Reg. 1489, January 7, 1977).

In applying the existing regulations, the four corporate characteristics are: (1) continuity of life, (2) centralization of management,

(3) liability for corporate debts limited to corporate property, and (4) free transferability of interests (Treas. Reg. sec. 301.7701-2).

An organization is treated as having continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. In the case of a limited partnership, if the retirement, death or insanity of a general partner causes a dissolution unless the remaining general partners (or all the remaining members) agree to continue the partnership, continuity of life does not exist. The regulations provide that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act generally lacks continuity of life. Under these rules, continuity of life generally does not exist even if the remaining partners have agreed to continue the partnership.

An organization generally has centralized management, under the regulations, if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act generally cannot achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally does not have centralized management unless substantially all the interests in the partnership are owned by the limited partners. However, if all or a specified group of the limited partners may remove a general partner (even with a substantially restricted right of removal), the test for whether there is centralized management is to be based on all the facts and circumstances.

An organization is treated under the regulations as having limited liability if, under local law, there is no member who is personally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act (or the Uniform Limited Partnership Act), personal liability generally exists with respect to each general partner. In the case of a limited partnership, however, personal liability does not exist with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization, and when he is merely a "dummy" acting as the agent of the limited partners.

The Internal Revenue Service has taken the ruling position that a corporate general partner in a limited partnership does not have a substantial assets unless, in the case of a partnership with total contributions of less than $2,500,000, its net worth is greater than or equal to the lesser of $250,000 or 15 percent of the total contributions to the partnership, or in the case of a partnership with total contributions of $2,500,000 or more, its net worth is at least 10 percent of the total contributions to the partnership (Rev. Proc. 72-13, 1972-1 C.B. 735). If it meets these tests, however, it will be considered to have substantial assets, and the entity thus will be considered not to have limited liability, for advance ruling purposes. Taxpayers have successfully contended that there is no limited liability under the regulations if the corporate general partner is not a "dummy" acting as the agent of the limited partners (see *Larson v. Commissioner, supra*).

An organization is treated as having free transferability of interests, under the regulations, if members owning substantially all the interests have the power, without the consent of other members, to substitute another person as a member and to confer upon his substitute all the attributes of his interest. Although the regulations indicate, in an example, that free transferability does not exist where unanimous consent of the general partners is required for the assignee of a limited partner's interest to become a substitute limited partner, the *Larson* case (*supra*) found free transferability where the consent of the general partner to substitute limited partners could not be unreasonably withheld.

If an association has no more than two of these four corporate characteristics (in addition to the two factors that corporations and partnerships have in common), then under the regulations, it is treated as a partnership rather than a corporation for Federal income tax purposes.

2. S corporations

In general

Present law provides that S corporations (i.e., those corporations that meet the requirements imposed under Subchapter S of the Code and that elect S corporation status) are generally treated as conduits. Taxable income or loss of an S corporation generally is subject to a single shareholder level tax. Subchapter S was enacted in 1958 to minimize the effect of Federal income tax considerations on the choice of form of business organization, by permitting the incorporation and operation of certain businesses without the incidence of the corporate level tax.[9] Substantial simplifying changes to the provisions of Subchapter S were enacted in the Subchapter S Revision Act of 1982.[10]

Significant differences remain between S corporations and partnerships, however; for example, corporate liabilities are not included in a shareholder's basis for his interest in the corporation, and special allocations are not a feature of S corporations. 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. The issue of entity classification is not important in obtaining pass-through tax treatment for an S corporation, because only corporations can receive S corporation treatment, and any eligible corporation (generally, one meeting the requirements described below) may simply elect to be subject to the provisions of Subchapter S.

Requirements for S corporations

Under present law, to be eligible to elect S corporation status, a corporation may not have more than 35 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), estates and certain trusts are permitted as

[9] *See* S. Rept. No. 1983, 85th Cong., 2d Sess., 87 (1958).
[10] *See* S. Rept. No. 97-640, 97th Cong., 2d Sess., 6 (1982).

shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than half the stock (sec. 1362). Despite these limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the size of such a corporation.

There is no requirement that an S corporation be engaged in an active business. Excess passive investment income can, however, cause the automatic termination of S corporation status in some circumstances if an S corporation was previously a C corporation and still has C corporation earnings and profits. In such a case, if the S corporation has passive income amounting to more than 25 percent of its gross receipts for 3 consecutive years, the corporation loses its S corporation status (sec. 1362(d)). This rule is intended to prevent a regular C corporation from electing S status and converting, essentially, into a holding company, rather than liquidating and incurring tax at the shareholder level on liquidation proceeds from the period of operation as a C corporation.

S corporations generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the corporate level (secs. 1363 and 1366). Items of income (including tax-exempt income), loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders. A shareholder's deduction for corporate losses is limited to the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, it generally is carried forward to the next year. The shareholder's basis in his stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock, by distributions, and the shareholder's basis in his stock is increased by his share of the corporation's income (sec. 1367).

In general, a shareholder is not subject to tax on distributions unless they exceed the shareholder's basis in his stock of the corporation or, in general, unless the corporation was formerly a C corporation and has remaining earnings and profits (sec. 1368). To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax in the hands of the shareholders.

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences.

First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if (for less than 3 consecutive years) the corporation has subchapter C earnings and profits, and has gross receipts more than 25 percent of which are passive investment income for the year (sec. 1375).

Second, present law (as modified by the 1986 Act) also provides that a corporate-level tax is imposed on certain gain of an S corporation that was formerly a C corporation. The corporate-level tax applies to any gain that arose prior to the conversion of the corporation to S status ("built-in gain") and is recognized by the S corporation, through sale, distribution or other disposition within ten years after the date on which the S election took effect (sec. 1374). The total amount of gain subject to corporate-level tax, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S corporation status.

3. Trusts

Generally under present law, a trust is taxed as a separate entity. The trust receives a deduction for distributions to beneficiaries, however, and beneficiaries generally include the distributed amounts in income.

Grantor trusts

A grantor trust is not treated as a trust for Federal income tax purposes, but rather the incidence of taxation falls upon the grantor, because the grantor is treated as the owner of the trust (sec. 671). In general, a grantor of a trust is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income, if, as of the inception of that portion of the trust, the value of the reversionary interest exceeds 5 percent of the value of that portion of the trust (sec. 673). The grantor of a trust generally is also treated as the owner if he (or a nonadverse party) has certain powers to control beneficial enjoyment of the corpus or income, or has certain administrative powers over the trust, or has the power to revoke the trust in some circumstances, or may distribute or accumulate the income for the grantor or the grantor's spouse or use the income to pay premiums on insurance on the life of the grantor or the grantor's spouse (secs. 674-677). Thus, in general, if the grantor retains sufficient powers or obtains sufficient current benefits from the trust, he is treated as the owner.

Entity classification of trusts

Treasury regulations provide criteria distinguishing trusts (other than grantor trusts) from partnerships and corporations for tax purposes (Treas. Reg. sec. 301.7701-4). The regulations provide that, in general, the term "trust" refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Under the regulations, an arrangement generally will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore are not associates in a joint enterprise for the conduct of business for profit.

Since the four characteristics discussed above that distinguished partnerships from corporations generally are common to trusts and corporations, the regulations apply the other factors—namely the presence of associates and an objective to carry on business and divide the gains therefrom—in distinguishing a trust from a corporation for Federal income tax purposes (Treas. Reg. sec. 301.7701-2(a)(2)).

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Thus, an entity will not be treated as a trust if the trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership (e.g., a Massachusetts business trust) (Treas. Reg. sec. 301.7701-4(b)).

The regulations provide that an investment trust (sometimes also called a "management trust") is generally treated as an association taxable as a corporation, where there is a power under the trust agreement to vary the investment of the certificate holders. Nonetheless, where there is not such a power under the trust agreement (e.g., a fixed investment trust or unit investment trust), the entity will not be treated as a corporation. However, a trust with multiple classes of interests generally is treated as a corporation even if there is no power to vary the investment. (Treas. Reg. sec. 7701-4(c)).

Organizations that are commonly known as liquidating trusts (i.e., organized for the primary purpose of liquidating and distributing the assets transferred to such a trust) and similar organizations generally are treated as trusts (Treas. Reg. sec. 301.7701-4(d)). A liquidating trust is treated as a trust because it is formed with the objective of liquidating particular assets and not for the purpose of carrying on a profit-making business that normally would be conducted through a corporation or partnership. If the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation is lost or abandoned, the organization may no longer be treated as a trust.

4. Other passthrough entities

a. Real estate investment trusts

Under the provisions of the Code applicable to real estate investment trusts (REITs) (secs. 856 *et seq.*), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary operations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests (except in its first year of REIT status, when fewer than 100 holders are permitted), and would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being, in substantial part, realized from certain real estate and real estate-related sources. Many of the requirements were altered by the Tax Reform Act of 1986 (P.L. 99-514) (the 1986 Act).

The ability of a REIT to engage in regular business activities is limited by several different requirements. First, there is the general requirement that services provided in connection with the rental of real property be rendered through an independent contractor in order for the rent to qualify toward the REIT's income requirement. Certain services may, however, be provided without violating the "independent contractor test." Such services are rent-related services, the provision of which would not result in the receipt of "unrelated business income" by an organization subject to tax on such income. Thus, amounts received by the REIT in connection with the rental of real property would not fail to be treated as rents from real property if the REIT provides only certain services other than services that are considered rendered to the occupant of the property.

Second, there is the imposition of a 100-percent tax (prohibited transaction tax) on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property). Safe harbors are provided; for example, a REIT may make up to seven such sales under one safe harbor. Under an alternative safe harbor, the REIT may make any number of sales during the taxable year, provided that the adjusted basis of the property sold does not exceed 10 percent of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year.

Third, there is the requirement that income from the sale or other disposition of stock or securities held for less than one year, or real property held less than four years, must account for less than 30 percent of the REIT's income. In addition, income is not treated as being derived from qualified sources if it permits the corporation directly or indirectly to derive profits from an active business.

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. The minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction) is reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. A REIT may receive the dividends paid deduction for a taxable year for dividends paid within a short period following the close of the REIT's taxable year. Nevertheless, certain dividends paid by the REIT following the close of each calendar year may be subject to a nondeductible excise tax of 4 percent to the extent that the REITs income for the calendar year exceeds its distributions for the year by more than a specified de minimis amount. Dividends paid out of the REIT's ordinary income generally are includible as ordinary income to the shareholders.

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its tax on capital gains and are taxable as capital gains to the recipient shareholders. For purposes of determining the maximum amount of capital gain dividends that a REIT may pay for a taxable year, the REIT may elect not to offset its net capital gain with the amount of any net operating loss, whether current or carried over from a previous taxable year.

b. Regulated investment companies

Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets, or is excepted from, certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements (some of which were modified by the 1986 Act).

The ability of a RIC to engage in an active business is limited by several of these requirements. First, the requirement of registration under the Investment Company Act of 1940 limits the activities that the RIC may engage in. Second, the requirement that most of the RIC's assets must be and most of its income must be derived from stock or securities assures that the RIC cannot engage in any business activities unrelated to investing in stock or securities. This assurance is bolstered by certain diversification requirements, which generally prevent RICs from exercising managerial authority as a result of substantial stock ownership. Permitted income for RICs nevertheless includes foreign currencies and options and futures contracts, derived with respect to the RIC's business of investing.

In addition, the ability of a RIC to actively engage in the business of trading securities is limited by the requirement that less than 30 percent of the gross income of the RIC may be derived from gain on the sale or other disposition of stock or securities, options, futures or forward contracts, or except as provided in regulations, foreign currencies held for less than three months. For purposes of applying this test, any increase in value on a position in a stock or security that is part of certain hedging transactions is offset by any decrease in value (whether or not realized) on any other position that is part of such hedge.

A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Rules similar to those applicable for REITs apply to distributions of capital gain dividends and to distributions of amounts after the close of the calendar year.

c. Real estate mortgage investment conduits

In general.—A real estate mortgage investment conduit (REMIC) is an entity created by the 1986 Act. In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors.

In general, if certain statutory requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein, under specified rules. Holders of "regular interests" generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest. Holders of "residual interests" take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests. Certain special rules apply with respect to the income taken into account by holders of the residual interests. Present law also prescribes rules relating to the treatment of taxpayers who exchange mortgages for interests in the REMIC and the treatment of disposition of interests in the REMIC.

Entity classification.—The pass-through status of the REMIC applies regardless of whether the REMIC otherwise would be treated as a corporation, partnership, trust, or any other entity. Thus, for example, in the case of a REMIC that would be treated as a partnership if it were not otherwise a REMIC, the provisions of subchapter K of the Code would not be applicable to any transactions involving the REMIC or any of the holders of regular or residual interests.

d. Cooperatives

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception—the cooperative may compute its taxable income without regard to amounts paid to its patrons as patronage dividends. In general, patronage dividends are amounts that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate may be in a number of different forms.

In general, a cooperative is permitted to compute its taxable income without regard to patronage dividends only to the extent of net income derived from transactions with its members. Thus, cooperatives generally are subject to corporate tax on profits derived from transactions with nonmembers. In addition, if an entity qualifies as a tax-exempt farmers' cooperative under section 521(b) of the Code, it generally may deduct patronage dividends to the full extent of its net income and also may deduct, to a limited extent, dividends on its common stock.

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

e. Cooperative housing corporations

Under present law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued by the cooperative to the extent that such amounts represent the taxpayer's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative that is paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative that is paid or incurred by the cooperative with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc., of the cooperative's buildings. Where a cooperative housing corporation charges each tenant-stockholder with a portion of the cooperative's interest or taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes attributable to such tenant-stockholder's dwelling unit, then the cooperative may make an election whereby the share of the cooperative's interest and taxes that each tenant-stockholder is permitted to deduct would reflect the amounts that were so separately allocated and charged.

In general, a cooperative housing corporation is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders. A tenant-stockholder generally is any person (not just an individual) owning fully paid up stock in the cooperative corporation, the purchase price of which bears a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

B. Corporations and Shareholders

By contrast to the treatment of partnerships and partners, C corporations and shareholders generally are each separately subject to tax on distributed corporate income. The shareholders do not calculate tax liability by reference to the corporation's income; instead, the corporation pays tax on its income. The shareholders generally include in their income amounts that the corporation distributes to them. Although discussed in more detail below, the principal rationale for imposing a corporate income tax as well as a shareholder-level tax on distributions is that the corporation is a separate entity for business, accounting, and legal purposes, and thus economic reality (as well as concern for administrability of the tax law) dictates that it be subject to tax separately from its shareholders.

In general

Corporations are subject to tax on their taxable income (secs. 11, 1201) or, if greater, to the tax imposed under the corporate alternative minimum tax (sec. 55). Taxable income is generally the taxpayer's gross income less deductions. Net losses of the corporation for a taxable year are not passed through to shareholders, but generally are carried back or forward to offset the corporation's income for other taxable years (sec. 172).

Contributions

Present law provides for tax-free contributions by shareholders to corporations, similar in some respects to tax-free contributions by partners to partnerships, if certain requirements are met. No gain or loss is recognized to the corporation or to the contributing shareholder, in the case of contributions of property to a corporation solely in exchange for stock or securities of the corporation, by one or more persons who have control of the corporation immediately after the exchange (sec. 351). Control is defined for this purpose as ownership of at least 80 percent of the stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (sec. 368(c)). The control requirement for tax-free contributions by shareholders differs from the treatment under the partnership rules, which do not require that the partner control the partnership for his contribution to be tax-free.

Distributions

Dividend distributions by corporations to shareholders are generally subject to shareholder-level tax (sec. 301). Dividends are generally those amounts representing distributions from the corporation's earnings and profits (secs. 301(c), 316). An exception is provided for distributions of the corporation's stock, which are generally not treated as taxable dividends to the shareholders (sec. 305). Distributions to shareholders with respect to the corporation's stock, in excess of the amount constituting a dividend, are treated as tax-free return of basis to the extent of the shareholder's basis in the stock, and as gain thereafter (sec. 301(c)). Unlike partnership distributions, corporate dividend distributions (other than stock dividends) generally do not affect the shareholder's basis in his stock.

Shareholders are also subject to tax in the case of liquidating distributions by the corporation; the amount received by a shareholder as a liquidating distribution is treated as received in exchange for his stock (sec. 331). Thus, the shareholder includes in income the excess of the amount received in liquidation over his basis for his stock.

The distributing corporation is also subject to tax upon distributions of appreciated property under present law as amended by the 1986 Act, whether the distribution is a liquidating distribution or not (secs. 311, 336). The corporation may recognize a loss upon the distribution of property in liquidation, but not upon the nonliquidating distribution of property with respect to its stock. An exception is provided from the requirement that the corporation recognize gain upon a distribution of property with respect to its stock, in the case of distribution of its stock (or rights to acquire its stock) (sec. 311(a)(1)), which is also generally not treated as income to the shareholder.

Affiliated groups

One structural difference between partnerships and corporations is that an affiliated group of corporations may elect to file a consolidated return, which has the general effect of treating the group as one corporation for purposes of calculating income tax liability (sec. 1501, Treas. Reg. sec. 1.1502-2). In general, an affiliated group of corporations means one or more chains of corporations where the common parent corporation directly owns at least 80 percent (by vote and value) of at least one other corporation in the group, and at least 80 percent (by vote and value) of the stock of each other member of the group is owned directly by one or more of the other corporations permitted to be in the group (sec. 1504(a)). Applicable Treasury regulations provide detailed rules for the administration of this concept, including limitations on the use of loss carryovers of one member of the group to offset income of other members arising in years when they were not members of the group (Treas. Reg. sec. 1.1501-1).

Under the consolidated return regulations, intercompany dividends are eliminated in calculating the tax liability of the group (Treas. Reg. sec. 1.1504-14). This rule has the effect of not imposing shareholder level tax until the income is distributed outside the affiliated group.

In addition, present law provides a dividends received deduction for corporations if they are not members of an affiliated group filing a consolidated return (sec. 243). Dividends received by a corporation from another corporation are fully deductible, if the payor corporation would be treated as an affiliate (as described in the previous paragraph), but no consolidated return election is in effect. If the payor corporation would not be treated as an affiliate, the dividend received is still 80 percent deductible.

Thus, the dividends received deduction and the consolidated return rules generally cause dividend distributions to corporate shareholders to be either tax-free, or taxed at a very low effective rate, until the amounts are distributed outside of corporate solution.

Present law provides no comparable rules for affiliated or commonly owned partnerships; the above result, however, is similar to the treatment of income of tiered partnerships. A partner in the top tier partnership generally includes in income his distributive share of income of the top tier partnership, which would include a share of income of indirectly owned partnerships. No distinction is made among different types of partners (e.g., corporations or individuals).

Entity classification

As discussed in more detail above (see 1. Partnerships, *supra),* Treasury regulations currently in effect provide criteria for distinguishing partnerships for corporations for Federal tax purposes. In general, the regulations provide that if an association has more than two of four listed corporate characteristics, it is classified as a corporation rather than a partnership. The four corporate characteristics are: (1) continuity of life, (2) centralization of management, (3) liability for corporate debts limited to corporate property, and (4) free transferability of interests.

Liabilities; allocations; inside basis

Unlike partnership liabilities, corporate liabilities are not included in the shareholder's basis for his stock. Nor are special allocations to shareholders of corporate income or loss (or items thereof) provided, because corporate income or loss is taxed at the corporate level, not at the shareholder level. The basis of assets held at the corporate level is not stepped up to fair market value when stock changes hands.

C. Master Limited Partnerships

In general

Master limited partnerships are generally thought of as limited partnerships whose limited partnership interests are publicly traded like corporate securities on an exchange or over the counter (for example, on the New York Stock Exchange or through the NASDAQ system). Under applicable Federal securities laws, unless a registration exception applies, such limited partnership interests are normally required to be registered with the Securities and Exchange Commission, and in some cases will also be required to be registered under applicable State securities laws as well. The limited partnership, as an issuer of registration-required securities, generally is required to file annual and quarterly financial reports (Forms 10-K and 10-Q) with the Securities and Exchange Commission.

Large, widely held limited partnerships, or those whose interests are publicly offered or are registered under Federal or State securities laws are not necessarily publicly traded, on an exchange, over the counter, or otherwise. Some commentators use the term publicly traded limited partnerships (rather than "master limited partnerships") to refer specifically to limited partnerships whose interests are publicly traded.[11]

Master limited partnerships have become substantially more numerous in recent years, since the first such partnership whose interests were traded on a stock exchange was formed in 1981.[12] The formation of these types of limited partnerships has followed several patterns. The most common types of formation transactions can be termed: (1) the rollout (or drop-down) type of transaction, (2) the acquisition (or equity buyout) type, (3) the rollup type, and (4) the corporate liquidation type. The most prevalent types appear to be the rollout and the acquisition types. The liquidation type is significantly less advantageous to the liquidating corporation from a tax standpoint, since the 1986 Act has taken effect, because a corporation is now generally subject to tax on appreciated property distributed in liquidation.

In many of the transactions by which MLPs are formed, part of the impetus for the transaction stems from the appeal of the tax savings that can be effected by conducting a business in partnership form (with one level of tax) rather than in corporate form (with two levels of tax). The formation of an MLP often (but not

[11] Lyman, "An Overview of the Origin and Tax Treatment of Publicly Traded (Master) Limited Partnerships," supra note 6.
[12] *Id.*

always) involves the transfer to the partnership of corporate assets or a business activity theretofore conducted in corporate form. Interests in publicly traded limited partnerships can be sold to investors in the same manner as corporate stock and, like stock, provide free transferability and limited liability. Such interests can be marketed as producing a better after-tax yield on current cash return than corporate stock because of tax savings. The following is a more detailed discussion of these types of MLP formation transactions, and their variants.

Formation transactions

Rollout (drop-down) transactions

A rollout is a transaction whereby a corporation rolls out (or drops down, depending on one's preference for terminology) corporate assets to a limited partnership in exchange for an interest in the partnership. The corporation (often referred to as the corporate sponsor) is typically the general partner of the partnership, and may also receive an interest as a limited partner (i.e., limited partnership units). The contribution of assets to the partnership in exchange for a partnership interest is generally treated as a tax-free contribution both to the partnership and to the contributing corporation (sec. 721).[13] The corporation generally receives a basis in its units equal to the basis of the assets transferred to the partnership (sec. 722). The partnership's basis for the contributed assets generally is the same as was their basis in the hands of the contributing corporation (sec. 723). Thus, if the corporation contributes property whose basis is less than its value, the unrealized appreciation will be subject to tax when the partnership disposes of the property in a taxable transaction.[14]

When the property is contributed to the partnership, limited partnership units are distributed to the public. Three principal alternative means of distributing units to the public are available: (1) a primary offering (sale of limited partnership units directly by the partnership to investors, normally using an underwriter); (2) a secondary offering (sale by the corporation of its limited partnership units to the public); and (3) a distribution by the corporation to its shareholders of limited partnership units.

In a primary offering or a secondary offering, investors buying units are not subject to tax upon the distribution. In the case of a distribution of the units by the corporate sponsor to its shareholders, however, the distribution is normally treated as a dividend, and the value of the units is includable in the income of the recipient shareholders (secs. 301(a) and (c)). In the case of the acquisition

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[13] The tax-free nature of the transaction could be affected, for example, in cases where the contributed property is encumbered by debt which the partnership pays off, and the payment is treated as an indirect transfer of money to the contributing partner. If the contribution and the indirect transfer, when viewed together, are properly characterized as a sale or exchange of property, then the contributing corporation may be treated as recognizing gain on the transaction (sec. 707(a)(1)(B)).

[14] Such inherent gain (as well as income, loses and deductions) with respect to contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (sec. 704(c)). The total gain, income, loss and deduction allocated in accordance with this rule cannot exceed the amount of gain, income, loss, or deduction realized by or allowable to the partnership (the "ceiling limitation") (Treas. Reg. sec. 1.704-1(c)(2)).

of partnership units other than by a contribution transaction (e.g., by purchase), the investor's basis in his units is generally their cost (sec. 742).[15]

The tax treatment of the sponsoring corporation differs depending on the means by which limited partnership units are transferred to the public. In the case of a primary offering, there are generally no tax consequences to the corporate sponsor.[16] In a secondary offering, however, the corporate sponsor generally must include in income the gain (including income from recapture and unrealized receivables) attributable to its units that are sold to the public (secs. 741, 751). Similarly, in the case of a distribution of limited partnership units to its shareholders, the corporation is subject to tax on the difference between its basis in the distributed units and the fair market value of the units (sec. 311(b)).

Acquisition (equity buyout) transactions

This type of MLP formation transaction frequently involves a corporate sponsor (like the rollout). The primary difference between a rollout-type transaction and an acquisition-type transaction is that in the former, the corporation contributes assets to the partnership, whereas in the latter, the partnership buys the assets from the sponsoring corporation or from unrelated parties. An acquisition-type transaction may be arranged to buy particular assets, or to buy unidentified assets generically (e.g., rental real estate).

Generally, in an acquisition transaction, a limited partnership is formed (with the corporate sponsor, if any, typically serving as general partner), and limited partnership units are sold to the public in a primary offering. The cash raised through the offering of units (plus any additional amounts borrowed by the partnership) are used to acquire assets by the partnership. Because the partnership acquires assets by purchase, generally its basis in the assets will initially be their cost (which presumably equals their fair market value at the time of purchase) (sec. 1011).

Investors buying limited partnership units in the offering generally will also have a cost basis, which should approximate the value of the assets of the corporation.[17]

The corporate sponsor (or other person) who sells assets to the partnership recognizes gain or loss [18] on the sale. This result can

[15] In the case of a primary offering not involving an underwriter, or involving a best efforts underwriting (where the underwriter is simply the sales agent rather than the initial buyer of the units), the acquisition of the partnership units generally is treated as a contribution governed by sec. 721, and the unit holder's basis is determined under sec. 722 to be the amount of money he contributed (plus the basis of property, if any, that he contributed). The distinction between acquiring units by purchase and by contribution is important principally in determining the unit holder's inside basis for partnership assets. Where a partner acquires an interest in a partnership by purchase, and the partnership has made a "section 754 election," the partner may step up his share of the partnership's basis in its assets to reflect his purchase price (secs. 754 and 743(b)). This can be advantageous to a partner should the partnership sell appreciated assets, for example, and the appreciation in the assets was reflected in the price he paid for his unit. This treatment is not available for partnership units acquired by contribution.

[16] But see note 12, *supra*.

[17] Because partners include partnership-level liabilities in their basis for their partnership units, a limited partner's basis in his unit will generally approximate the cost to the partnership to acquire its assets, even if the partnership borrows (using nonrecourse debt) to acquire them.

[18] If the corporate sponsor has a greater than 50 percent interest in the partnership, no deduction is allowed to the corporation in respect of losses on the sale (sec. 707(b)).

be contrasted to the treatment of the corporate sponsor that contributes assets, generally tax-free, in a rollout transaction. Even if (in a rollout) the corporate sponsor sells units at a gain in a secondary offering, the corporation is generally (depending on whether the transfer of debt to the MLP results in income to the corporation) subject to tax only on the gain inherent in the units that it chooses to sell, not on the full gain inherent in the assets transferred to the MLP as in an acquisition-type transaction. This makes the acquisition-type transaction less attractive than a rollout to a corporate sponsor that has substantially appreciated assets that it wishes to transfer to the MLP.

Rollup transactions

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.

The tax consequences to the pre-existing partnerships (and to their partners) are that they generally do not recognize gain or loss on the contribution (sec. 721). Their basis in the MLP units is the same as their basis for the contributed assets (sec. 722). On the distribution of the units to the partners, the partners generally do not recognize gain or loss (sec. 731), and have a basis in the units equal to their basis in their interests in the pre-existing partnerships (sec. 732(b)).

The master limited partnership generally does not recognize gain or loss on the contribution of assets in exchange for units (sec. 721), and has a basis in the contributed assets equal to the basis of the assets in the hands of the pre-existing partnerships (sec. 723). Unrealized gain or loss in the assets acquired by the MLP is not eliminated.[19] Thus, in general, rollup transactions are likely to be tax-free to the participants in the transaction.

Liquidation transactions

A liquidation transaction for forming an MLP involves the complete liquidation of the corporation whose assets the MLP acquires. In the transaction, the corporation contributes all of its assets to the MLP in exchange for units of the MLP. The corporation then distributes the units to its shareholders in complete liquidation.

The corporation generally recognizes no gain or loss upon the contribution of its assets to the partnership in exchange for partnership units (sec. 721), and its basis in the units is the same as the basis in the transferred assets (sec. 722). Thus, any built-in appreciation in the assets is preserved in the units. Under present law, as amended by the 1986 Act, a corporation recognizes gain on the distribution of appreciated assets in liquidation (sec. 336). In addition, the amount of recapture of tax benefits is subject to corporate

[19] But see the discussion of terminations, below.

tax at ordinary income rates (e.g., sec. 1245). The 1986 Act repeal of the *General Utilities* rule (which provided for nonrecognition of gain by a corporation upon the distribution of property in liquidation) means that a liquidation transaction for forming an MLP is substantially less attractive for a corporation with appreciated assets (unless the corporation has losses sufficient to offset all or a significant part of the liquidation gain).

The tax consequences to the shareholders of the liquidating corporation upon receipt of the MLP units is generally that gain is recognized to the extent the value of the units exceeds their basis in their stock (sec. 331). Consequently, their basis in their units includes the amount of gain recognized upon the distribution (sec. 334(a)), and normally equals the fair market value of the units immediately after the distribution. Thus, in a liquidation transaction, initial cost to the distributee shareholder of acquiring the units is only the tax liability attributable to the distribution, not the full purchase price as in a transaction involving a primary offering.

Operation of the MLP

Several other issues arise in the ongoing operation of a master limited partnership in connection with the fact that its partnership interests are publicly traded. First, partners may have to recognize investment credit recapture, and depreciable partnership assets may become subject to different depreciation rules, among other consequences, if a sufficiently large number of units (i.e., 50 percent or more of the total interests in partnership capital and profits) are sold or exchanged in any 12-month period (sec. 708(b)), causing a termination and re-formation of the partnership for tax purposes. Second, depending on the type of transaction by which the partnership was formed, different limited partnership units may not be treated as fungible, because they have differing tax attributes. In addition, the tax consequences to tax-exempt and foreign investors differ from the consequences to other investors.

Terminations

In general, under present law, a partnership is considered terminated for tax purposes if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits (sec. 708(b)). A tax termination is not necessarily a dissolution of the partnership under applicable State law. Instead, the partnership is deemed for tax purposes to distribute its properties to the partners in proportion to their respective interests in the partnership properties. Immediately thereafter, the partners are deemed to contribute the properties to a new partnership (Treas. Reg. sec. 1.708-1(b)(1)(iv)).

Generally, a termination requires the closing of the partnership books. A termination also triggers recapture of credits, and generally causes depreciable property to be treated as newly placed in service (possibly under a different depreciation scheme, if it was originally placed in service before 1987). Thus, in general, a termination may require partners to include additional amounts in income, and also could cause the inclusion of two taxable years of partnership income in one taxable year of the partner if the partner and the partnership are not using the same taxable year (due to the closing of the books).

A termination of a publicly traded partnership may not be an unlikely event; it could occur, for example, as a result of trading of more than half of the interests in the partnership during a year. It may be difficult to properly apply the termination rule, when publicly traded partnership units are held in street name and it may not be obvious that more than half of the units have changed hands within a year. A termination could also result from an underwriting arrangement for a public offering of partnership units in which the underwriter is treated as the partner, and the purchasing investors are treated as acquiring their units in a sale or exchange.

Fungibility of limited partnership units

If limited partnership units are to be traded in a public market like a stock exchange, over the counter, or the like, it is generally considered important that the traded units, like shares of stocks of the same class, all have the same economic and tax attributes. Units do not automatically have the same tax attributes; for example, where the corporate sponsor contributes property and acquires units in the transaction by which the MLP was formed, tax attributes of the contributed property are allocable to the corporate sponsor's units (sec. 704). Further, the "ceiling rule" (which limits the amounts so allocable to the total such amounts allowable to the partnership) may also apply, if the basis of the property contributed is lower than the amount of each contributed by the other partners. If the ceiling rule applies, the tax attributes that can be allocated in accordance with this rule are limited, creating further distortions in the tax attributes among the units.

As another example, where the initial public investors acquire their units by contribution, any adjustments made to the basis of partnership property to take account of appreciation in value (and increases in trading prices) of the units (sec. 754) apply only to partners who subsequently acquire their units by sale or exchange, not to the original contributing partners. Similarly, if a secondary offering of units (e.g., to raise more cash) subsequently occurs, the newly offered units may also have different tax attributes. Some master limited partnerships have attempted to make curative allocations of partnership items of income or deduction to counteract the tendency towards tax differentiation among traded units.

Treatment of tax-exempt limited partners

Under present law, tax-exempt organizations are generally subject to tax on unrelated business income (sec. 511). Generally, tax-exempt organizations that are limited partners of a master limited partnership are treated as engaged in the business activity of the partnership, and are normally subject to unrelated business income tax on income (including income from debt-financed property) from a partnership.[20] Thus, although such income is in fact subject to

[20] An exception to the unrelated business income tax is provided in the case of debt financed real property, provided the property is not leased back to the seller and certain other requirements are met (sec. 514(c)(9)).

only one level of tax (i.e., at the partner level), tax-exempt organizations have been reluctant to acquire partnership interests. In comparison to other possible investments that do not normally generate unrelated business income to such organizations (such as corporate stock), partnership interests have no greater tax benefit to tax-exempt organizations than to taxable investors. A further disincentive for such organizations to invest in partnerships is the possibility that they will have to file State tax returns in jurisdictions where the partnership is doing business.

Treatment of foreign investors

Nonresident aliens and foreign corporations are generally subject to United States income tax (absent treaty exemptions) at regular rates on income that is effectively connected with the conduct of a United States business (secs. 871(b), 882(a)). Such a foreign person is treated as engaged in a United States trade or business if he is a partner in a partnership engaged in business in the United States (sec. 875). Thus, in general, such foreign persons are subject to United States income tax on business income earned in the business of a partnership in the United States. Further, withholding may be imposed on some types of distributions (secs. 1441, 1442, 1446), and on gains from the disposition of United States real property interests (sec. 1445).

III. ANALYSIS OF TAX ISSUES

A. Master Limited Partnership Issues

Under present law, MLPs can be classified as partnerships because they typically lack at least two of the four "corporate" characteristics as defined in the applicable regulations. For example, they lack "continuity of life" because the partnership is formed under a state law corresponding to the Uniform Limited Partnership Act and they lack "limited liability" under the standards that have been developed for identifying that factor.

The principal issue arising from the tax treatment of master limited partnerships is whether present-law conduit treatment of such entities is appropriate. The most frequently advanced idea for altering the present-law conduit treatment of master limited partnerships is to treat them as C corporations, subjecting their income to two levels of tax (corporate and shareholder). A number of such proposals are described below, along with arguments for and against the proposals.

Reclassifying publicly traded or publicly offered limited partnerships as corporations for tax purposes is not the only possible alternative. For example, some have suggested retaining a one-level tax structure for these entities, while modifying the way it applies to ensure that the tax is collected. For example, it has been suggested that the tax be paid by the owners of the entity on its earnings that are distributed to them, and by the entity on earnings that it retains. It has also been suggested that the present-law conduit treatment not be altered but that instead, withholding at the entity level on income taxed to owners be instituted. Other suggestions to improve compliance and collection have also been made—for example, suggestions to improve information about the identity of the beneficial owners of interests, such as forbidding the holding of interests in "street" name.

Another single-level tax regime that has been suggested is to permit no passthrough of losses, and to require annual distribution of net taxable income of the entity, with collection of the tax on the income at the entity level. Under this regime, the entity would not be permitted to maintain any significant long-term debt, nor would special allocations or partnership elections to step up the basis of assets for purchasing partners (sec. 754 elections) be permitted. Income from this type of entity would be treated as portfolio income under the passive loss rule.

The entity classification issue can be viewed broadly as a question of the appropriateness of one level of taxation on business earnings under the circumstances, as well as involving related questions such as administrability and interrelation with other rules, such as the passive loss rule.

Proposals

Treasury Department

In testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on June 9, 1986, the Treasury Department recommended that publicly traded limited partnerships be subject to tax as corporations. In testimony before the same Subcommittee on June 30, 1987, the Treasury Department again made the same recommendation, suggesting also that Congress consider extending the current statutory pass-through models to include activities such as natural resource development.

In addition, in the November 1984 Treasury Department *Report to the President on Tax Reform for Fairness, Simplicity and Economic Growth* (the "Treasury report"), Treasury proposed treating as corporations those limited partnerships with more than 35 limited partners. The proposal was not included in the May 1985 *President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.*

ALI Subchapter K Project

The American Law Institute Federal Income Tax Project on Subchapter K (1984), at 392, proposes that publicly traded limited partnerships be subject to tax as corporations.

Senate Committee on Finance Staff Report

The Senate Committee on Finance Preliminary Staff Report (October 1983) concerning recommendations for taxation of corporations, also included a recommendation that publicly traded limited partnerships be subject to tax as corporations. The final Staff Report (Senate Committee on Finance, the Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff (May 1985) at 2) does not include the recommendation because of the fact that at the time the final report was published, the 1984 Treasury report had recently been published including the broader 35-limited-partner proposal, and the Staff determined that it would not approach the issue in a piecemeal manner.

Analysis

Corporate level tax system and similarity to corporations

Those who support proposals to change the classification of MLPs argue that publicly traded limited 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. Consequently, these types of entities and their holders should be treated similarly for tax purposes.

They further argue that, whatever the merits of the present-law system of double taxation of corporate income, Congress has expressly retained it. It is inconsistent and unfair to allow some businesses electively to integrate the corporate and shareholder level taxes, simply by choosing to operate as a master limited partnership rather than a corporation. Similarly situated taxpayers should be treated the same.

Those who oppose taxing master limited partnerships as corporations make several arguments regarding the similarity between such partnerships and corporations. One threshold argument is that the double-level corporate tax system of present law is irrational and creates inefficiencies. Therefore, it should not be expanded beyond its present scope to encompass master limited partnerships as well.

That double taxation of income earned in corporations is theoretically wrong is based on the premise that, ultimately, all income tax liability is borne by individuals, either directly or indirectly in the form of increased costs of goods and services or decreased return on services or capital. It is argued that the two-tier tax on corporate income imposes a greater tax on income earned in corporations and thus is unfair; further, it creates distortions in investment decisions that lead to economic inefficiency.[21] The preferable model would have the effect of taxing an individual owner on his share of corporate income in the year earned, some argue, which is comparable to the way a partnership and its partners are taxed. Thus, current treatment of MLPs represents a theoretically correct result that should not be overturned, just because it is different from the (arguably theoretically incorrect) way that similarly situated corporations and shareholders are taxed.

Some who favor elective integration of the corporate and shareholder levels of tax question the use of publicly traded limited partnerships as the means for accomplishing this goal. They argue that integration is beneficial because it increases the likelihood that investment decisions will be made on economic, not tax factors, i.e., that integration increases the neutrality of the tax system as a theoretical matter. However, they question whether it is desirable to accomplish integration through a system that imposes a tax on investors regardless of whether they have received distributions, as the partnership conduit tax system does. Because the investor in an MLP is taxed currently on his share of partnership income, there may be strong investor pressure to make distributions so that partners will receive the income on which they are paying tax (or at least an amount sufficient to pay the tax currently). Other possible systems of integration could create less pressure for current distributions, and more readily permit the retention of earnings. For example, they suggest that the European gross-up and credit system, or even a dividends-paid deduction system, may be more desirable.

Others argue that elective integration and shareholder levels of tax should not only be permitted, but indeed encouraged through the use of master limited partnerships. Furthermore, elective integration through continued use of master limited partnerships does not have one of the criticized features of some other proposals for integration: it does not give a windfall (in the form of increased stock value) to existing corporate shareholders, who paid a price for

[21] For example, corporations may tend to retain rather than distribute earnings in order to minimize the second-level shareholder tax, or they may incur undesirable levels of debt capitalization because earnings distributed as interest are not taxed at the corporate level.

their stock that was lower than it otherwise would have been, to take account of the corporate-level as well as shareholder-level tax on earnings on that stock.

Another issue is whether it is appropriate to classify a limited partnership as a corporation for tax purposes largely on the basis of public trading. Historically, free transferability of interests has been one of several factors that have been considered important to classification. In 1976, the Tax Court concluded that the existing regulations tend to classify as partnerships entities that might be viewed as bearing a strong similarity to corporations, and effectively invited the Treasury Department to change its regulations, *Larson* v. *Commissioner,* 66 T.C. 158 (1976), acq. 1979-1 C.B. 1. The partnerships involved in that case were not publicly traded, though the court did find that their interests were freely transferable.

Proponents of drawing the line at the point of public trading contend that the types of entities observed to be publicly traded MLPs are virtually indistinguishable from corporations in all their significant aspects, are accessing public capital markets in a manner traditionally performed by corporations, and in addition present unique administrative issues and enforcement concerns if the tax law relating to partnerships is applied to MLPs. In this connection, they also contend that one reason publicly traded limited partnerships present administrative difficulties is that the partnership rules contemplate an entity in which the identity of the investors is known and transfers of interests are easily identifiable. Public trading, they contend, involves a degree of lack of identity of the investor with the entity that particularly justifies separate taxation of the entity, rather than partnership conduit treatment. Accordingly, they conclude that MLPs are particularly appropriate for classification as corporations, regardless of the treatment of other limited partnership entities.

Others contend that a classification standard based on public trading would tend to discriminate against relatively smaller investors who are able to make the minimum investment typically required by an MLP and who seek liquidity. Wealthier investors, who do not seek the same degree of liquidity, can still invest in other partnerships that are not publicly traded and that may require a substantially greater minimum investment than MLPs would require.

Some also contend that other factors (for example, limited liability) may be more significant indicia of corporate similarity than public trading. They contend that MLPs meet the present law standards regarding such factors and that if there is a problem with the present law standards, they should be reexamined generally, not changed solely in the case of MLPs.

Motivations for forming MLPs

Some argue that increased investment in MLPs is principally tax-motivated. They point to changes in the tax law under the Tax Reform Act of 1986 that make 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. Furthermore, 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 ordinary income. 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 a portion of the excess of the income that is reported for financial purposes over the amount of corporate alternative minimum taxable income.

In light of these changes, it is argued, many businesses (whether or not they seek access to public capital markets) may find it advantageous to operate in a non-corporate, single-level tax form whenever possible. Master limited partnerships, some argue, are used principally to obtain these tax advantages.

Others argue that the tax treatment of master limited partnerships simply facilitates desirable economic and business goals that are the primary reason for the formation of MLPs. For example, a rollout transaction often has the principal purpose of enhancing the value of the corporation's stock by highlighting certain corporate assets that previously were undervalued. The transaction can also permit the removal of debt from the corporation's books, further enhancing the value of the corporation's stock. In addition, by removing desirable assets from the corporate structure, the transaction may serve as a protective measure against hostile takeovers.

Another business reason stated for forming a master limited partnership is to raise capital without incurring additional debt, and without diluting the interests of existing shareholders. Also, it is contended, MLPs may offer business advantages over other present-law passthrough entities, such as REITs or RICs, which are restricted in the types of investments, nature of income, or management arrangements they may have (even though entities such as REITs may be more attractive than MLPs to certain tax-exempt investors, due to unrelated business income concerns). In the case of acquisitions (equity buyout) MLP transactions, the formation of the partnership permits the corporation to accomplish a buyout of subsidiary assets without debt and possibly at a higher price than otherwise possible. Thus, it is argued, MLP formation takes place for legitimate and substantial business reasons and should not be curtailed.

Erosion of the corporate tax base

Supporters of proposals to tax publicly traded partnerships as corporations argue that the continued growth of master limited partnerships may cause erosion of the corporate tax base, and a serious revenue problem eventually will result unless Congress takes action.

They assert that master limited partnerships conduct business activities that otherwise would be conducted in corporate form. They point to the fact that the formation of many master limited partnerships has been through transfer of assets of a corporate sponsor to the partnership; even in a rollup transaction, the business activities of the partnerships are of a type that may be conducted by corporations. Thus, to the extent that such activities would have generated income subject to two levels of tax in corporate form, and such activities are subject to only one level of tax when conducted in partnership form, the corporate revenue base is eroded.

Opponents say that disincorporation through the use of master limited partnerships may not cause a serious revenue problem, or may not cause a significant loss of short-term revenue from the corporate tax base. There are several alternative arguments that have been made in this regard. Each argument is based on the premise that the use of master limited partnerships represents a new financing option for corporate managers for funding corporate investment activities, and suggests that this new option is absorbing capital that otherwise would have been applied to finance corporate activities in a way that would not have generated a double tax in the first place.

Existing methods of obtaining capital for corporate activity are principally the following: (1) raising funds through issuing corporate stock (equity financing); (2) raising funds through borrowing (debt financing); and (3) using retained corporate earnings.

The earnings on an equity-financed corporate business activity are subject to the double tax, to the extent they are paid out, because the corporation is taxed when it earns the income, and the taxable holders of the equity (shareholders) are taxed when the income is distributed to them. Thus, equity-financing a project may have a relatively high tax cost.

The earnings on a debt-financed corporate business activity, by contrast, are generally not subject to two levels of tax to the extent paid as interest, because the interest on the debt is deductible and shelters the income earned at the corporate level from the corporate tax. The only level of tax paid on such earnings is paid by the person to whom the income is distributed. To the extent the income is paid in the form of interest to the lender, and the lender is a taxable entity, the income is subject to tax in the lender's hands. Some lenders (such as pension funds) may be tax-exempt, however, so income on debt-financed corporate activities that is paid to a tax-exempt lender escapes both levels of tax normally applicable to income earned in a corporation. To the extent that corporate income is not paid out as interest but is used to amortize principal or otherwise exceeds the deductible interest amounts, it may be taxed at the corporate level (as well as to the shareholder). Because the overall tax cost of debt-financing a project is less than equity-financing it, it is said that debt financing is a less costly method of financing than is equity financing.

Corporations may also use retained earnings to finance their business activities. Retained earnings generally represent after-tax income of the corporation, but to the extent these amounts are not distributed to shareholders, and instead are used to finance income-producing activities of the corporation, only the earnings from the income-producing activity (to the extent they are distributed to shareholders) are subject to two levels of tax; the amounts used to finance the project are subject to only the corporate level of tax (which under present law is higher than the individual rate). The price of the corporation's stock may, however, reflect the retention of earnings, and thus market turnover in the stock (for the period of retention) will generate taxable gains.

Those who argue that the growth of master limited partnerships may erode the corporate tax base assert that investments in MLPs are in whole or part a replacement for investments in corporate equity rather than corporate debt or other vehicles for corporate financing that would not generate two levels of tax. They assert that corporate debt in general (or debt in the economy) may not be declining, and argue that even if a particular corporation replaces its debt with MLP equity, others will borrow the amounts not borrowed by that corporation.

They also assert that if MLP capital is, to some degree, replacing retained-earnings financing by corporations, it replaces capital the income on which is ordinarily subject to two levels of tax. While the retained earnings are not distributed and thus themselves not subject to current shareholder level tax, the corporation's stock increases in value to reflect the retention of earnings, so that to the extent there is turnover in the stock there is current taxable gain. The future distribution of the retained earnings may generate losses should the stock decline in value to reflect the corporation's decline in net worth after the distribution, but the tax on the distribution of earnings to shareholders would offset such losses. Thus, they argue, retained-earnings financed projects should be considered as taxed comparably to equity-financed projects, and the replacement of retained-earnings corporate financing with MLP capital financing may cause a reduction in tax attributable to the loss of corporate-level tax on the entity's income. Also, earnings on MLP financing may be taxed at individual tax rates, rather than at the higher corporate tax rates.

Some who argue that MLPs will not erode the corporate tax base assert that capital contributed to master limited partnerships is equivalent to corporate debt. Corporations tend to transfer debt-encumbered assets to master limited partnerships, and the debt is then frequently paid off with the equity capital raised by offering the master limited partnership units to the public. Thus, they argue, the amounts invested by the public in master limited partnerships (income which is subject to one level of tax) are replacing corporate debt. Corporate debt-financed income is subject to one level of tax due to the deductibility of interest (as described above). They also assert that tax-exempt organizations tend not to invest in partnerships due to the unrelated business income tax consequences, so that MLP partners are generally taxable persons. Thus, they argue, the replacement of corporate debt with master limited partnership equity (also subject to one level of tax) should not generate a revenue loss, and is not likely to erode the corporate tax base.

Some also argue that MLP capital partially supplants the use of retained earnings to finance corporate business activities. It is argued that corporations will cut their dividend payments to finance investments sooner than they will issue new stock, because, they argue, retained-earnings-financing has a relatively low cost compared to new equity financing. Another reason for making the choice to cut dividends rather than issue stock, it is said, is to avoid diluting the holdings of existing shareholders.

To the extent that they can raise capital indirectly through MLPs in which they are general partners, however, corporations can maintain dividend levels. Thus, the fact that MLP earnings are subject to only a single level of tax is offset by the earlier distribution (rather than retention) of earnings to shareholders, and earlier tax on those distributed earnings. Those who take this position suggest that future growth in the corporate tax base may be eroded, however, to the extent that capital is invested in MLPs instead of corporate equity.

Finally, opponents of taxing MLPs as corporations assert that erosion of the corporate tax base through disincorporation is caused by the reversal in the differential between the corporate and individual tax rates. Under the tax rates set by the 1986 Act, the corporate rate is higher than the individual rate, and this motivates investors to select forms of investment taxed at individual rather than corporate rates (such as partnerships and S corporations). The incentives to disincorporate would be diminished, they argue, if the corporate rate were lower instead of higher than the individual rate. They also point to the fact that capital gains are taxed at a higher rate, since the 1986 Act, as a further disincentive to invest in corporate stock. It would not be necessary to tax master limited partnerships as corporations if the corporate and capital gains rates were reduced.

Administrability

Supporters of taxing master limited partnerships as corporations argue that trying to apply the partnership tax rules to the operations of a publicly traded entity is overwhelmingly complex. Those rules were never designed for publicly traded entities, they argue. It is virtually impossible to ensure that income is being accurately measured; further, enforcing the results of audits of partnerships with thousands of holders is highly impractical. The concept that a partnership terminates if more than half its interests change hands, as is true under present law, is thoroughly inconsistent with the notion of public trading. Further, it is argued, the fact that fungibility of master limited partnership units is a serious concern in every master limited partnership formed other than by a single primary offering is an indication that tax status as a partnership is incompatible with public trading.

Opponents of treating master limited partnerships as corporations acknowledge that the partnership rules are complex, particularly in application to publicly traded partnerships, but point out that the rules have always been complex, and that the corporate rules are also complex. They argue that the flexibility provided by the partnership rules should be preserved. They assert that the administrability concerns, though serious, are not insurmountable. In answer to the concern that it is difficult to ensure that income is accurately measured and reported, it has been suggested that withholding on partners' income at the partnership level be instituted, as a means of ensuring that the sophisticated calculations needed are done consistently.

Other opponents of treating master limited partnerships as corporations have suggested that administrative concerns be addressed by restricting partnership allocations, basis adjustments, and long-term debt, and requiring collection of tax liability at the partnership level, while preserving single-tax treatment for income (with no passthrough of net losses). They argue that this set of simplifications would respond to concerns regarding administrability by eliminating the applicability of rules leading to enforcement difficulties, and would also substantially solve audit and tax collection issues that some perceive under present law. Those recommending this regime for publicly traded limited partnerships also contend that treating income of the entity as portfolio income under the passive loss rule would have the same effect as treating the partnerships as corporations paying dividends (which are generally portfolio income), without having to impose a harsh two-level tax regime.

Competitive advantage

Supporters of taxing master limited partners as corporations assert that their use gives some taxpayers a tax-created competitive advantage. They argue that mature businesses with a steady cash flow, that can be marketed effectively as public partnerships because of the tax-advantaged yield, are unfairly favored over start-up companies or those with high capital expenditures, which cannot take advantage of the master limited partnership structure. Favoring one type of business investment over another creates new economic inefficiencies of the type that the 1986 Act was designed to reduce.

Opponents say that master limited partnerships have a limited utility. As a financing technique, they are available to large, mature business that already have a choice of financing method including the use of debt, retained earnings or newly obtained equity capital, and that thus already have an economic advantage over other types of companies. It is not a problem specifically attributable to the use of master limited partnerships that causes a competitive disadvantage, but a condition of the market place. Eliminating a possible competitive advantage for some companies is consequently not a reason to change the tax treatment of master limited partnerships, they argue.

Avoidance of the passive loss rule

Supporters of taxing master limited partnerships as corporations contend that they can be used to eviscerate the passive loss rule unless they are treated as corporations. Because activities owned in the form of limited partnership interests are treated as passive activities (except as provided in regulations which have not been issued), master limited partnerships could be used to generate passive income for the purpose of absorbing passive losses that otherwise would not be currently deductible. Income from master limited partnerships is essentially equivalent to corporate dividends, in that it arises from business activities ordinarily conducted in corporate form, and represents a steady stream of positive income. Therefore, master limited partnerships should be treated as corporations, and the income from them should be acknowledged as portfolio income (that cannot generally offset passive losses, under the passive loss rule).

Opponents of this notion point out that the passive loss rule contains a specific grant of regulatory authority to the Treasury Department to treat net income or gain of limited partnerships as portfolio income. This regulatory authority is broad enough to treat the income of any limited partnership, not just publicly traded limited partnerships, as portfolio income, they argue. Consequently, legislative action to treat master limited partnership income as portfolio income by transforming it into dividend income through reclassification of such partnerships as corporations is not necessary.

B. Other Partnership Issues

Other partnership tax issues, not specific to master limited partnerships but affecting partnerships generally, have been raised by some commentators. Such issues include those relating to partnership allocations, and to the treatment of partnership liabilities.

Partnership allocations

As described in Part II.A., above, present law permits partners substantial flexibility in allocating among themselves items of partnership income, gain, loss, deduction and credit, so long as the allocation has substantial economic effect. Some have argued, however, that the statutory standard is vague, and that the recently promulgated Treasury regulations setting forth guidance as to when allocations have substantial economic effect are flawed. The regulations may allow sufficent flexibility in arrangements among partners that they essentially permit the sale of tax benefits by tax-exempt or low-tax partners to high-tax partners. Although the passive loss rule enacted in the 1986 Act substantially curtails the current use of losses to shelter non-passive income in the case of partners who are individuals, the passive loss rule has no application in the case of widely held corporations. Thus, it is contended that the opportunity still exists to sell tax benefits through the use of partnership allocation techniques. In particular, allocations based on nonrecourse debt, and shifting allocations, may offer such opportunity.

Allocations with respect to nonrecourse debt

Current Treasury regulations have been criticized as too generous, especially with regard to allocations of losses attributable to nonrecourse debt. Since any special allocation to a partner which is attributable to nonrecourse liability is without economic effect, such an allocation, in order to comply with the requirements of the statute, must be determined in accordance with the partner's interests in the partnership. Some suggest that an approach such as that of the regulations, looking principally to whether the partner would be subject to tax on potential gain arising from foreclosure or disposition of the nonrecourse-financed property is not a sufficient standard under the statute for determining a partner's interest in a partnership. The regulations, however, exclude from consideration other facts and circumstances, particularly facts bearing on the economic sharing of profits and losses aside from tax consequences, which would be required to be considered in determining whether allocations not attributable to nonrecourse liability satisfy the statutory standard.[22] It has been suggested that the validity of an allocation of partnership losses attributable to nonrecourse debt should be evaluated on the basis of the relative investment by the partners, and the economic sharing of cash from operations, proceeds from a sale of assets, and proceeds from a refinancing of assets.[23] The application of the regulations to nonrecourse liabilities has been criticized as offering a vehicle for the transfer of tax benefits similar to safe harbor leasing.[24]

Others have contended, however, that the regulations, insofar as they relate to the treatment of losses attributable to nonrecourse debt, are a valid and appropriate interpretation of present law. It is contended that a direct owner of property could take deductions attributable to basis provided by nonrecourse debt (even though the lender bears the economic risk of loss) and would be charged with gain to the extent of the difference between the reduced basis and the outstanding debt on disposition of the property. Thus, it is argued, partners holding property through a partnership should be able to receive the same treatment, whether or not the partnership involves shifting allocations, so long as the partner who receives the deduction would ultimately bear the gain-chargeback.

Shifting allocations

The statutory "substantial economic effect" test has been interpreted to permit shifts in partnership allocations. Both courts [25] and the Internal Revenue Service [26] have taken the position that shifts in allocation ("flip-flops") are valid under section 704(b).

For example, in a typical flip-flop, often a large proportion of a newly formed partnership's initial losses and deductions (perhaps 99 percent) flow through to partners with high taxable incomes who can use the tax benefits. This allocation arrangement frequently remains in effect until these partners have recouped their initial investments, and perhaps some additional return, whereupon the allocation shifts so that losses (which are much smaller after the initial years) and profits and distributions (which may have increased if the partnership's business has obtained a firm footing) are allocated in greater proportion to the partners who are tax-exempt, or in a low tax bracket. This type of flip-flop can serve the purpose of giving investors an initial high-ratio writeoff, while keeping a substantial profits interest for the tax-exempt partner.[27]

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[22] For example, an article written prior to the promulgation of the proposed regulation suggested that a gain-chargeback provision would not satisfy the statutory requirements as applied to nonrecourse liability and that the allocation of tax benefits must be compared to economic benefits calculated without regard to tax benefits in order to determine the validity of the allocation. Krance and Sheffield, "Beyond Orrish: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved," 60 *Taxes* 937 (1982).

[23] American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 251.

[24] Comments of the Committee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983), at 32-38 (regarding the regulation as proposed).

[25] See, e.g., *Hamilton v. U.S. 687* F.2d 408 (Cl. Ct. 1982), holding that allocation of partnership losses and income primarily to limited partners until "payout" (recoupment of their capital contributions), and thereafter a shift in allocation of these items primarily to general partners, did not constitute nonrecourse loans from the limited to the general partners, but rather both allocations were valid.

[26] Treas. Reg. sec. 1.704-1(b)(5), Example 16(ii).

[27] Congress has discouraged some flip-flops designed to achieve other objectives. For example, leveraged buy-out transactions have been structured so that a corporation with large net operating loss carryovers and a new corporation formed by buy-out investors enter into a partnership

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It has been suggested that the opportunity to sell tax benefits, rather than capital recoupment or profit motive, is the reason for structuring shifting allocations in a partnership agreement. Thus, shifts in allocation could be treated as invalid. For example, a shifting allocation might be invalid where a substantial part of a partner's expected return on investment is likely to be derived from tax savings rather than from ultimate economic profit in the venture). In such circumstances, an appropriate allocation could be redetermined on the basis of each partner's interest in the partnership, taking into account the partner's share of distributions, liquidation proceeds, and proceeds of refinancing partnership profits, as well as the extent of his maximum risk of economic loss (regardless of tax losses).

It has often been said that the provisions of subchapter K were crafted to afford partners flexibility in arranging their affairs. Thus, a proposal to invalidate shifting allocations, where a substantial part of an investors' return is likely to be derived from tax savings, might be criticized as inappropriately preventing partners from arranging the tax results of their agreement in a manner which reflects the true economic reality of the transaction. Thus, for example, if partners all agree that the price of a partnership interest comprised of receiving an allocation of 99 percent of partnership losses and profits until the initial contribution is recouped, followed by an allocation of 60 percent of partnership profits, is equal to 99 percent of the partnership's initial capital requirements, then this arrangement should be respected for tax purposes. It is also argued that if an investor's expectation of recouping his investment is speculative or contingent, and he may actually lose his money, the investment is in the nature of equity, and tax losses, reflecting the possible economic loss of his investment, should be permitted to flow through to him under a shifting allocation arrangement.

Proponents of invalidating shifting allocations might argue that part of an investor's expected return from an investment with a high initial loss allocation to him may consist of the tax savings which the immediate tax sheltering affords. Thus, the "economics" of the investment are in part determined by its tax results. To the extent the partner is allocated an initial share of losses greater than his ultimate share of profits, it has been argued that the transaction resembles a small capital contribution and a larger loan by the partner to the partnership. (This resemblance might arguably increase if the investor realistically expected the venture to repay his initial investment.) Instead of interest, he initially receives tax savings. When the amount of the hypothetical loan has

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which acquires the assets of the target profitable corporation and incurs the debt for the acquisition. The profits of the partnership were allocated 90 percent to the loss corporation for a limited period of time (for example the period over which cash flow of the venture is expected to be used to pay down the debt incurred to acquire the assets). Thereafter, profits of the partnership were allocated 90 percent to the other corporation. The loss corporation would be entitled to distributions with respect to its capital account build-up during the initial period, but over a very long period of time (e.g., 25 years), with a relatively low amount of guaranteed payments in the nature of interest. The transaction was intended to utilize the loss corporation's loss carryovers to facilitate the amortization of the acquisition debt. It also avoided certain limitations on the use of loss carryforwards that might apply if the loss and the profit corporation otherwise combined. The limitations on loss carryovers in the 1986 Act were intended to limit this type of transaction among others.

been recouped, he is left with a small equity participation in the form of a profit share. Thus, arguably, it is reasonable that the allocation of losses to him attributable to the sum he in effect loaned the partnership should be invalid, and allocations to him should be redetermined to reflect his interest in the partnership. Others contend that in the absence of a fixed obligation to repay the investment, the investor should not properly be viewed as a lender.

Some may contend that even if an investor's interest is in the nature of equity, the long-standing law permitting special allocations of tax losses encourages arrangements that constitute sales of tax benefits and warrants reconsideration.

Opponents could contend that invalidating certain shifting allocations is unwieldy and complex, and would virtually require a case-by-case analysis, especially in the case of different allocation ratios of different partnership items (such as depreciation, interest deductions, and the like). Thus, shifting allocations should continue to be permitted.

Treatment of partnership liabilities

As discussed in Part II.A, above, a limited partner generally includes in his basis for a partnership interest his share of nonrecourse liabilities of the partnership. This rule, in effect, increases the amount of partnership losses and deductions that a limited partner can deduct, in view of the limitation on the deduction of such amounts to a partner's basis in his interest. Other limitations on the deductibility of losses—such as the at-risk rules and the passive loss rules—may effectively nullify the inclusion of partnership liabilities in a partner's basis as a means of increasing the amount of deductible partnership losses, at least in the case of taxpayers to whom those rules apply. The at-risk rules and the passive loss rules do not, however, apply to widely held corporations. As a consequence, the issue of whether partnership liabilities, particularly nonrecourse liabilities, should be included in a corporate limited partner's basis, remains subject to debate.

Some assert that partnership recourse liability should be included in a limited partner's basis to the extent he could be personally liable for such debt, but that nonrecourse liability should not be included in basis because partners are not generally personally liable for such debt.[28] Under this notion, a partner's basis would be increased by his share of partnership recourse liabilities, to the extent he could be required to satisfy them (in the case of a limited partner, to the extent of his contribution obligation). It has been argued that such an approach might place more significance on the

[28] See James S. Eustice, "Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Thoughts)," 39 *Tax Law Review* 345, 398 (1984). It is noted that this approach would "place extraordinary stress on the distinction between recourse and nonrecourse debt." *Id* at 399. Thus, another approach would be to give partners (and S shareholders) basis for entity debt without regard to personal liability, but it is also noted that such a rule would "perhaps facilitate tax shelters [and] . . . Congress may be reluctant to do anything that would facilitate tax shelters." *Id.* Current law provides that partners, but not S corporation shareholders, may include a share of entity debt in their basis for their interests. S corporation shareholders may include their basis in loans to the corporation in determining the maximum amount of losses which may be deducted by the shareholder.

distinction between recourse and nonrecourse debt than economic factors might warrant in particular cases.[29]

Others would prohibit the inclusion of any partnership-level obligation in a limited partner's basis for his partnership interest. Under this view, a limited partner would not be able to include any nonrecourse liability of the partnership in his own basis for his interest, nor would the partner be able to include recourse liabilities incurred by the partnership in his own basis, even in the amount of his unpaid obligation to contribute to the partnership. Thus, only the amount of money and the basis of property actually contributed would be included in a limited partner's initial basis for his interest.

The rationale of this approach is that limited partners have an indirect relation to partnership-level liabilities. Further, because of their passive investor status and limited liability, limited partners are said to more closely resemble corporate shareholders, who may not include corporate debt in the basis of their stock, than they do direct owners of the leveraged property. This approach would thus treat limited partnerships as separate entities, rather than conduits, in determining the effect of partnership liabilities on a limited partner's basis. The effect of such a change would generally be to limit the deductions a limited partner could take from the limited partnership to the amount of his actual paid-in capital contribution (increased by his share of any undistributed partnership income and reduced by any actual distributions to him).

Those opposing such a proposal say that permitting inclusion of partnership recourse liabilities in a limited partner's basis can be said to give the same tax advantages as does debt financing of directly owned property.[30] This result is justified, some argue, because limited partners, like direct owners, could be required to satisfy such liabilities (at least to the extent of their unpaid contribution obligations).

The rule including a share of nonrecourse liabilities in a limited partner's basis for his interest (thereby permitting him to deduct greater partnership losses), has been similarly justified as an adaptation to the limited partnership situation of a principle based on the decision the United States Supreme Court in *Crane* v. *Commissioner,* 331 U.S. 1 (1947). Under the *Crane* approach, the basis of directly owned encumbered property generally includes the amount of the debt (including nonrecourse debt), for purposes of depreciation; when such property is disposed of, the amount realized includes the amount of the debt, for purposes of determining gain in the transaction. The recent case of *Tufts* v. *Comm'r,* 461 U.S. 300 (1983) treated the amount of the nonrecourse debt, even though in

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[29] The distinction between recourse and nonrecourse debt "sometimes has considerable economic significance, but sometimes it has very little. It means much, for example, if a speculative stock is acquired on 90% margin, but not so much if a well constructed building in a stable neighborhood is purchased with a 40% down payment." Eustice, supra note 46, at 399.

[30] The approach of eliminating partnership recourse debt, up to the amount of a limited partner's future contribution, from a limited partner's basis has been criticized as not appropriate, where the future contribution is paid in at the time the recourse debt comes due and is used to pay it, on the ground that the contribution obligation is "so much like a general partner's liability" that it should be included in basis. American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 262-263.

excess of the fair market value of the property, as an amount realized.

Some assert that changing the current rule to exclude all partnership liabilities from a limited partner's basis would be fair, if the current rule is excessively generous in a limited partnership context. While limited partners would be treated differently from direct owners and general partners, the difference in treatment can be justified, proponents suggest, because limited partners more closely resemble owners of corporate stock than direct owners of partnership property. They also argue that the *Crane* rule on which the current rule regarding nonrecourse liabilities is based would not be generally abrogated, [31] but would simply become inapplicable in the limited partnership context to which it was extended.[32]

Opponents of the change could further argue that, even though a limited partner would under the changed rule be prevented from currently deducting partnership losses attributable to partnership liabilities, he would nevertheless have to take into account his share of partnership income attributable to them.

Proponents contend that this is not necessarily an unfair result if the losses which are disallowed due to noninclusion of partnership liabilities in a limited partner's basis are simply deferred and deducted against the limited partner's share of future income of the partnership, or when the partner actually pays any remaining contribution obligation.

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[31] Indeed, some have argued that the *Crane* principle of inclusion of nonrecourse liabilities in basis should be eliminated. See *Tufts* v. *Comm'r*, 651 F.2d 1058 (5th Cir. 1981) at n. 9, reversed, 461 U.S. 300 (1983).

[32] Although the current rules regarding a limited partner's share of partnership liabilities included in his basis for his interest are stated in Treasury regulations, it has been suggested that legislative authority would be required to change them due to the Congressional reenactment of various sections of the Code since regulations were promulgated. See American Law Institute. *Federal Income Tax Project—Subchapter K* (1984), at 259, n. 4.